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TREATMENT OF THE EUROPEAN FINANCIAL STABILITY FACILITY (EFSF) IN NATIONAL ACCOUNTS

Background note

I/ Introduction

On 9 May 2010, the EU Member States reached an agreement upon a comprehensive package of measures for Member States "in difficulties caused by exceptional circumstances beyond such Member States' control." This is referred as the "European Financial Stabilisation Mechanism" ("EFSM").

As part of this mechanism, on 7 June 2010, the 16 euro-area Member States signed an agreement related to the European Financial Stability Facility (EFSF) that could be activated, until mid 2013, up to a maximum amount of €440 bn, at the request of a Euro Area Member State facing some financing difficulties.

From a legal point of view, this entity was created as a "société anonyme" (limited liability company) in Luxembourg, with a small amount of capital subscribed by the EAMS on the basis of their share in the ECB capital.

The aim of the EFSF is to grant loans to an EAMS under the conditions agreed by the other EAMS providing an explicit guarantee to all the financing needed by the EFSF for this purpose.

Eurostat has analysed the implications of the creation of EFSF for national accounts recording. The conclusion is that the EFSF cannot be considered as an autonomous international organisation and that, therefore, all the debt it would incur on markets, excluding the value of the Loan Specific Cash Buffer, should be allocated to the guarantor EAMS, on the basis of their contribution key in a given support operation. In parallel, the loans granted by the EFSF should be considered as loans directly granted by these EAMS.

II The analysis of the EFSF under the national accounts framework

1) The EFSF is not an institutional unit according to ESA95 criteria

The EFSF has a complete set of accounts and is a legal entity, with full juridical capacity. However, this is not sufficient for being considered as an institutional unit which can be separately recorded in national accounts.

The provisions in the Agreement on EFSF¹, summarised in part III of this document, show that it has no autonomy of decision for carrying out the tasks resulting from its principal function which is to launch a financial rescue operation: the decision-making power regarding the initiative of launching a financial rescue operation lies in fact in the Euro Group, which represents the euro-area Member States (EAMS).

EFSF has thus no power of initiative regarding liabilities incurred in its own name:

- 1) The EFSF can choose neither the beneficiaries of its loans, nor the amounts to be provided nor the main conditions of such loans.
- 2) As regards the liabilities apparently incurred on its own name, it has no power of initiative as these are conditional to decisions taken by the EAMS, through the Euro Group.
- 3) The issuance of debt instruments can only take place under the condition of guarantees commitments, for each funding transaction, and not as a general commitment as it is the case for some government-controlled entities.

This strong dependency from the Euro Group is not only observed for “exceptional decisions” or for a “strategic framework”, as it is normally the case for “normal” corporations under the control of their shareholders, but it is even specified for its current activity, i.e. for each transaction related to assets and liabilities to be recorded on its balance sheet, which represent the very substance of the entity and the main ground for its existence. Unlike normal corporations, most of the decisions of EFSF are to be made on a unanimous basis by directors that have to act consistently with decisions taken in Eurogroup meetings (see paragraphs 10.9 and 10.10).

The room for manoeuvre of the EFSF is small, even in the case of the investment management of the cash which it will not disburse to a borrowing country (the so-called “Cash reserve” and the “Loan Specific Cash Reserve”) as it must follow very limitative guidelines, which is not normally observed in the case of usual treasury management activities (notably with the possibility of various arbitrages on its own initiative).

More generally, by comparison, in the case of “normal” corporations, the ex-ante approval of the shareholders is not required for “daily” decisions with respect to its principle function. In the case of normal corporations, the Managers are entitled by the decision making bodies of the corporation to engage in some operations for which they enjoy flexibility for fixing the main conditions.

¹ See notably the Agreement parts 2 (“GRANT OF LOANS, FUNDING INSTRUMENTS AND ISSUANCE OF GUARANTEES”) and 3 (“PREPARATION AND AUTHORISATION OF LOAN DISBURSEMENTS”) that specify the procedure for implementing a support operation and provide evidence that the EFSF has no decision power. All decisions related to the core activity of the EFSF require to be approved by the Guarantors MS on a unanimous basis. In addition, part 10 on governance mentions that “Each euro-area Member State hereby undertakes to the other euro-area Member States that it shall vote as shareholder of EFSF consistently with the decisions taken by the requisite majority of Guarantors or euro-area Member States (as the case may be) within the framework of such Eurogroup meetings and that it shall ensure that the director which has been proposed for nomination to the board of EFSF by it acts consistently with such decisions.”

Therefore, on the basis of these observations, Eurostat considers that the EFSF is not really able to "take economic decision and engage in economic activities for which it is itself held to be directly responsible (...)" as stated in ESA95 2.12, this decision-making criterion being essential for considering an entity as an institutional unit.² As such, the transactions of EFSF are to be rerouted.

Moreover the EFSF cannot be considered as a financial intermediary

In itself, the lack of autonomy of decision means that the EFSF cannot be considered as a financial intermediary.³ But, notwithstanding this crucial aspect, it must also be stressed that the EFSF does not bear any risk, which is a fundamental criterion in ESA95 (see 2.33) for being classified as a financial intermediary, as all its financing is subject to guarantee and to credit enhancement described in the annex, so that there is no shareholder risks. Finally, the EFSF cannot enlarge/develop its activities by its own, to the same extent in which a "normal" financial institution would do. Moreover, the activity of the EFSF does not match the definition of financial auxiliary activities in ESA95.

The EFSF cannot be considered as an international organisation

Similarly, the EFSF cannot be considered as an international organisation. No international organisation has the status of a private company, which is the case with EFSF. Notably, in the implementation of their current activities, international organisations do not need ex-ante approval from other government entities. Their president/general manager is generally entitled a substantial discretionary power, or at least a significant margin of initiative, while there is no unanimity rule as regard decision-making but generally a simple or qualified majority principle.⁴

As a conclusion, Eurostat considers that the EFSF should be consolidated with the units controlling it.

² The notion of autonomy of decision must be clearly distinguished from the question of control. One results in the recognition of a unit in national accounts, the other concerns the sector classification of a unit. In ESA95 (§ 2.12) a fundamental condition as to constitute an institutional unit is a "decision making autonomy in the exercise of its principal function." This means that the board of directors and/or managers may take current decisions without being obliged to request an ex-ante approval by other units or shareholders exercising an ex-post control on the unit. For the EFSF, there is evidence that this is not the case. According to ESA 95, the concept of control does not mean approval for decisions related to the current activity, but refers mainly (§ 2.26) to "determining general corporate policy by choosing appropriate directors if necessary". Such control can be exercised through different forms (voting powers, veto rights, appointment/dismissal, etc.).

³ The agreement itself states that "*The EFSF is not a credit institution*", according to the legal definition in the EU. This can be seen from the amount of capital, initially foreseen at a maximum amount of 30 million euros, which is completely negligible compared to the potentially very high level of assets and liabilities envisaged in the agreement.

⁴ Also it is to be noted that 1) international organisations have generally a rather large domain of activity while the EFSF covers only a very restricted and pre-determined list of tasks, 2) most international organisations have frequently a significant staff and usually perform by themselves a large number of the tasks implied by their mission, 3) international organisations benefit from extraterritoriality privileges, as "enclaves" not part of the own economic territory where there are located (see for instance SNA2008 § 4.173), 4) no limited liability company such as the EFSF, registered in one country, has ever been treated as an international organisation in national accounts, 5) international organisations can normally decide to extend/expand the range of their activities up to a certain extent, 6) international organisations are usually not set just for a very limited amount of time (Under the current agreement, support operations through the EFSF could be carried out only until June 2013).

Under national accounts, where an entity has obviously no autonomy of decision and/or by evidence carries out a transaction on behalf of another unit (which means that all the characteristics of the transaction are defined by the latter), the transaction must be rerouted in the account of the unit that is recognised as principal, i.e. controlling it.⁵

This may also be achieved by treating the entity as an integral part of the principal, a process usually known as “consolidation”, where all the transactions of the unit fall under this principle. In national accounts and according to other international standards there are several possible cases where such consolidation is required. However, the EFSF shows the specificity to be controlled jointly by several governments which would be involved in its transactions on a case by case basis.

2) The EFSF cannot be consolidated with the Eurogroup or with any other EU institution

There would be no rationale for consolidating the EFSF with the Euro Group (or the Euro Working Group) or with an existing EU institution.

a) Under the current institutional arrangements, the Euro Working Group is neither recognised as a supra-national (government) unit nor as an official EU institution. It has no separate budget and no own staff. It is not an institutional unit. The EWG is simply an informal working group set up by the Ministers of Finance of the EAMS, in the framework of the ECOFIN configuration of the Council of the European Union. This has been recognised as such by a protocol (14) annexed to the Treaty of Lisbon.

b) The Euro Working Group is not acting on behalf or by delegation of the European Council. It represents only one part of the total members of the Council, which is not accountable for the decisions taken by the EWG on its specific area of responsibility.

c) The EFSF is not acting on behalf of the Commission, which does not play any decisive role in the setting up and the functioning of the EFSF. The role of the Commission, as mentioned above, simply concerns the examination of the pre-conditions necessary for requesting EAMS to be eligible for the loans, notably through the elaboration of a Memorandum of Understanding specifying the country’s various commitments. Its intervention is part of the global coordination activity of all supporting entities, including the IMF and the ECB. The Commission has no power of decision, as its propositions are not binding for those EAMS which would act as guarantors, and has no control over EFSF.

d) The agreement on 7 June 2010 was neither signed by the Euro Working Group as such, nor by ECOFIN on behalf of the Council, nor by any other European institution. It was signed, individually, by those individual MS which have joined the Euro area, as national authorities, and, moreover, not as members of the Euro Working Group.

e) The guarantees, as stressed above, are provided on an individual basis and not by the whole EWG as such. Thus, the investors in the EFSF will bear rights resulting from the

⁵ ESA95.1.41 states that « when a unit carries out a transaction on behalf of another unit, the transaction is recorded exclusively in the accounts of the principal. (“recognising the principal party to a transaction”)

guarantees that are not potential claims on the EWG as a whole but on some precise MS and for given amounts.

f) If a new EU MS adopts the euro (such as Estonia has done in 2011) it will have to sign the EFSF agreement as the Eurogroup membership does not mean an automatic participation in the EFSF mechanism, whereas the adoption of the euro would provide automatic membership of the EWG.

For the reasons mentioned above, the EFSF could not be treated as an "ancillary unit" which, in the current ESA95, should not be recorded separately but within the unit of which they support the activity, notwithstanding the fact that the financial tasks carried out by the EFSF are not mentioned in the ESA95 list of ancillary activities and that such units are deemed to be "servicing" another unit, or a group of a very similar nature, in the same economic territory, which does not seem the case EFSF.

3) The operations of the EFSF must be re-allocated to the EAMS under national accounts framework

The EFSF has no power of decision and initiative as regards its assets - the conditions are set beforehand and the EFSF cannot take any decision in this respect – and its resources – for which the EFSF has only a very small margin of flexibility. It appears that the EFSF will act on behalf of the EAMS, following their instructions and at their risks, carrying technical tasks, with no autonomy of decision.

EFSF is to be viewed as an "intergovernmental arrangement" that will effectively make more efficient the coordination and the implementation of mutual support within the Euro Area.

In substance, the intervention of the EFSF is similar to the direct support agreed for Greece by MS under the form of bilateral loans under a coordinated plan. The EFSF is a rationalisation in the decision procedure, avoiding uncertainty and delay.

It is worth noting in this respect that the support of Germany to Greece was provided through the financial institution KfW with the guarantee of the Federal Government. Nevertheless the corresponding financing has been included in the German government debt through rerouting.

As a consequence, the activity of the ESFS must give rise to a "reallocation" of assets and liabilities into the balance sheets of the Euro Area Member States.⁶ Debts instruments issued by the EFSF must be accounted as government debt of the MS according to their contribution key as guarantors as agreed in a given support operation.

However, for practical reasons, the part of the proceeds from the issuance of debt instruments that is kept by the EFSF as "Loan Specific Cash Buffer" will not be allocated to the guarantors Member States.

As far as the loans to a beneficiary country are concerned, they should be considered as directly granted by the supporting Member States.

⁶ It is worth noting that the share in equity capital of the EFSF cannot be used in such consolidation process, which must take into account each support operation (and even possibly for tranches under some events) that will show a specific key contribution of the EAMS as guarantors. This has only some practical implications but does not change the substance of the treatment in national accounts.

All the flows of income attached to the amount of the debt instruments issued by the EFSF rerouted to the guarantors Member States and to the amount of the loan granted to the beneficiaries countries, will be allocated to the guarantor Member States.

This treatment of the EFSF falls under the terms of the Eurostat decision of 2009 on the statistical recording of public interventions during the financial crisis.

Eurostat decided in 2009 that government-owned special purpose entities with no autonomy of decision are to be classified within the government sector. Only majority privately-owned special purpose entities which are established for a short temporary duration and have as a sole purpose the one to address the financial crisis, even if they receive a government guarantee, are to be recorded outside the general government, under certain conditions. EFSF is 100% owned by governments, and as such does not belong to this latter category.

4) Further guidance on the implementation of the rerouting

Eurostat will shortly deliver further guidance to National Statistical Offices and Statistical Departments of Central Banks on the practical implementation of the rerouting decision, regarding balance sheet items and revenue/expenditure items.

II/ Overview of the provisions of the June 2010 Agreement between the Members of the Euro area related to the EFSF⁷

1) The role of the EFSF

The EFSF will grant loans to the requesting EAMS on behalf of the supporting EAMS and ensure the appropriate financing by issuing debt instruments on the markets.

As specified in the agreement, its main tasks will be to *"make loans to EA Member States, finance such Loans by issuing or entering into Funding Instruments backed by Guarantees"* (preamble – (6)) granted by EAMS. Whatever the forms of such financing, they will all be *"backed by irrevocable and unconditional guarantees"* (preamble – (4)). The implementation procedure for this mission is described in §2 of the agreement.

At first, an EAMS must introduce a request for a stability support loan. Then the Commission, in liaison with the ECB and the IMF, will negotiate a memorandum of understanding and make a proposal to the Eurogroup Working Group (EWG) on the terms of a *"Loan Facility Agreement"* specifying the main conditions for the loan. The members of the EWG will then take a decision. The very detailed terms of the Loan Facility Agreement, at a technical level, will be negotiated by the EFSF in conjunction with the EWG, which will have to provide its approval. Details on loan disbursements are provided in §3 of the agreement related to the EFSF. Afterwards, the EFSF will have the task to structure its funding, either on a stand-alone basis or according to a debt issuance programme. As a matter of principle, the financing must *"have substantially the same financial profile as the related loans as to amount, time of issue, currency, repayment profile, final maturity and interest basis"*. There may be deviations, due to market conditions, but the approval of the EAMS will be required (§ 4 - (5)).

⁷ For further detail, see: www.efsf.europa.eu

For the funding of the EFSF *"each Guarantor shall be required to issue an irrevocable and unconditional Guarantee"* (§ 2 – (3)), on the basis of a *"contribution key"* based on their share in the capital of the ECB (e.g. 27.1% for Germany, 20.4% for France and 17.9% for Italy). This share will be grossed up to 120%, for enhanced quality purposes. In order to stick to the effective MS participation, the key will be adjusted for each support operation (and, in some cases, for each tranche).

The agreement related to the EFSF describes also the procedure relating to the guarantees at every stage: origination ("guarantee commitments"), obligations of MS, activation. Notably, §8 foresees the case of a "stepping out" procedure applied to MS that would be no longer in a position to take part in new guarantees commitments. It is clear that the guarantees are the main element of security provided to the investors in the case of the debt instruments issued by the EFSF but this has been supplemented by credit enhancement mechanisms that were necessary in order to obtain the higher rating on markets (here AAA), which means that the investors are assured of a very low probability of default. (See §.3). In this respect, should any shortfall occur in payments, after the activation of the guarantees by the EFSF, the latter could also use some "buffers" (funds raised on markets will be distributed to a borrower), while should the guarantees not be sufficient, part will be retained under two forms:

- On one side, a "cash reserve", equal to the NPV of the margin to be levied on the loan and that could be used as reserve for other loan operations but which may also be distributed to the guarantors under the form of dividends under some conditions. (See § 5)

- And, on the other hand, a "Loan-Specific Cash Buffer" used to cover shortfalls in payments by a borrowing country should the guarantees be insufficient and that is equal to the part of the debt instruments that are not covered by the guarantors rated AAA. If there will be no default, it will be used to redeem the debt instrument. If the guarantees are called, the funds available under the LSCB may be transferred to the guarantor Member States or maintained in the EFSF for possible future operations.

- Both elements must be invested in "best" AAA instruments issued in euro.

It is important to underline that the support is provided by the EAMS on an individual basis as *"no Guarantor shall be required to issue Guarantees which would result in it having a Guarantee Exposure in excess of its aggregate guarantee commitment"*. (§2 – (3))

In case one initial guarantor would step out, the Agreement does not foresee an automatic substitution by the remaining others and a specific decision will be needed (§8 – (2)). It is stated in the agreement related to the EFSF that *"each Guarantor ultimately bears only its Required Proportion of such aggregate Guarantee Liabilities"*. (§2 – (4)). Therefore, if a supporting MS could not answer to a call of guarantee for its committed amount, the investors would still have a claim on this MS to the extent of the above-mentioned amount. (§ 2 – (4) and § 7 – (1))

2) Overview on institutional arrangements

They are covered by the §4 of the Agreement related to the EFSF.

The management of EFSF is entrusted to a board of Directors, consisting of as many directors as there are EFSF shareholders (exclusively MS). Because of particular decision procedures, the EFSF is not entitled with common functioning rules for limited liabilities companies where

decisions are normally taken on a weighted basis more or less linked to the share in capital of the different shareholders. In the case of the EFSF, a substantial list of key decisions of the Board are to be approved on a unanimous basis, i.e. by all MS (§ 10 - (5)). These relate to the implementation of the core mission of the EFSF. Some corporate matters (such as increase in share capital, prolonging duration, liquidation, etc.) will also require a unanimous decision by all EAMS (§10 – (7)). Finally, only a few decisions will require a 2/3 majority, in line with common business practice. The agreement mentions also the strong dependence of the Board of Directors of the EFSF on its MS shareholders (§ 10 – (9)).

There are also substantial restrictions concerning the capital of the EFSF. The status of the EFSF mentions that *“The shares cannot be transferred by any shareholder during a period of 10 (ten) years from the date of acquisition of the shares by the relevant shareholder except with the unanimous consent of all shareholders. Such restriction does not apply to (i) the initial transfer by the sole founding shareholder (if any) to the other Member States whose currency is the Euro and (ii) proportionate transfers by each shareholder to any Member State who adopts the Euro as its currency after the incorporation of the Company. After the 10 (ten) year lock up period, transfers of shares can only be made to Member States of the European Union whose currency is the Euro in proportion to their shareholding in the Company.*

Some tasks may be provided by other units, such as the management of funds, the following of the loans, the investment of the treasury, the settlement operations, etc. (§ 12 – (1)). The EFSF may also delegate the funding operations to national debt agencies in EAMS. In this respect, it has been agreed that the German “Finanzagentur” (Debt management office-) will play an important role in debt issuances while the European Investment Bank will perform most back-office tasks.