European Financial Stability Facility

EFSF

Maximising the capacity of the EFSF

Terms and Conditions – 29 November 2011

On 26 October 2011, Heads of State or Government of euro area Member States agreed on maximizing the capacity of EFSF based on two approaches. They mandated the Eurogroup to finalise the terms and conditions for the implementation of these modalities in November, in the form of guidelines and in line with the draft terms and conditions prepared for the EFSF.

The two approaches achieve the objective of enlarging the capacity of the EFSF without increasing the euro area Member States' guarantee commitments underpinning the EFSF, respecting fully the rules of the Treaty. Within the terms and conditions of the ratified Framework Agreement, the options are designed to support the continued market access of euro area Member States under financial distress and safeguard financial stability of the euro area. The options could provide immediate and credible support, always linked to appropriate conditionality and seeking co-operation with the IMF, whilst preserving the credit standing of the EFSF and its objectives.

The rationales of the two approaches are:

- Option 1: Credit enhancement to primary sovereign bonds issued by Member States aimed at increasing demand for new issues of Member States' sovereign bond programmes and lowering the Member State's funding costs thereby supporting the sustainability of public finances.

- Option 2: The creation of one or more Co-Investment Funds (CIF) to allow the combination of public and private funding to enlarge the resources available to EFSF's financial assistance instruments. The CIF would aim to create additional liquidity and to enhance market capacity to fund loans. It would purchase bonds in the primary and/or secondary markets. Where the CIF would provide funding directly to Member States through the purchase of primary bonds, this funding could, inter alia, be used by Member States for bank recapitalisation.

Financing under options 1 and 2 will be linked to a Memorandum of Understanding entailing policy conditionality appropriate to the financial instrument chosen, and monitoring and surveillance procedures as specified in the EFSF Guidelines. Option 1 will be applied under the guidelines for precautionary programmes or under regular programmes. Option 2 will follow the guidelines on primary and secondary market purchases. These two financing approaches will strengthen the capacity to implement the tools available to EFSF – precautionary programmes, secondary market purchases, bank recapitalisation, as well as loans and primary market purchases, within the overall governance approach akin to EFSF financial support.

The following sections provide more detailed terms and conditions.

Option 1 – Sovereign partial risk participation

Product	Member State bond issued in combination with a Partial Protection Certificate of the same maturity as the attached bond. The sovereign bond and the Certificate are initially offered together to investors. The bond and the certificate will be detachable after initial issue and can be traded separately. For any Member State to have the benefit of the certificate, it will be necessary for the Member State to enter into a Memorandum of Understanding specifying inter alia conditionality, and a Financial Assistance Facility Agreement (FFA) with EFSF The Partial Protection Certificate gives the holder of the certificate an amount of fixed credit protection equal to 20% – 30% (to be determined in the light of market circumstances) of the principal amount of the sovereign bond to which it was initially attached.
Purpose	The main objective is to facilitate issuance by Member States at sustainable rates maximising EFSF capacity while providing a predefined degree of protection to investors.
Issuer	Sovereign bond is issued by Member States in line with their normal issuance process for a maturity decided by the Member State, in co-operation with the EFSF. The sovereign bond, identical in form to others issued by the relevant Member State, is issued at a lower yield than current market yields for the Member State, reflecting the partial protection provided by the certificate. The Partial Protection Certificate is issued by a special purpose vehicle (SPV) in Luxembourg for the same maturity as the bond to which it is initially attached. The SPV would not be legally connected to the EFSF or Member States.
Partial Protection Certificate	The certificate gives rise to a claim in the event of a Member State credit event under the full ISDA definition, which covers (i) failure by the Issuer to make full and timely payments of amounts scheduled to be due in respect of one or more bonds, subject to grace periods; or (ii) repudiation or moratorium; or (iii) restructuring These losses will be determined based on the ISDA procedures. The SPV shall finance the payments due by receipt of drawings made under a financial assistance facility agreement ("FFA"). The SPV will settle the claim by delivering cash or EFSF bonds. Under

	this route, the claim is unfunded until the time of a call. Upon investors' request it could be considered, that claims would be funded at the outset. The investor will be required, at time of claim or settlement, to demonstrate that they hold outstanding sovereign bonds of that Member State of at least the same principal value as the original bond covered by the Certificate.
Regulatory considerations	The necessary regulatory approvals or exemptions will be sought

Option 2 – Co-investment Approach

Product	Co-Investment Fund (CIF) established to invest in sovereign bonds of Member States, in primary and/or secondary markets. The CIF will have one or more compartment(s). Each compartment could either be dedicated to a single Member State or to more than one Member State. The CIF will have a predefined lifetime.
Purpose	The CIF will attract external capital sources to Member States' sovereign debt markets, maximising EFSF resources while providing a degree of protection to investors. The CIF will invest in sovereign bonds of a Member State which has entered into a Financial Facility Assistance Agreement (FFA) with EFSF. Where the CIF provides funding directly to Member States through the purchase of primary bonds, this funding could, inter alia, be used by Member States for bank recapitalisation. The CIF will as a rule hold the bonds to maturity, but could have some flexibility to sell them earlier in pre-defined circumstances under normal market conditions.
Issuer	The CIF will be a subsidiary of the EFSF, domiciled in Luxembourg. It will have a board of directors appointed by the EFSF. The investment policy of the CIF will be specified at the outset by the Board and will provide investors with clarity about how their interests will be protected through the CIF's decision-making and investment guidelines. The principles for buying bonds will be compatible with the approved guidelines for EFSF's purchases of primary and secondary bonds. The CIF will have three layers: First Loss Tranche, a Participating Tranche, freely tradable and potentially a third layer of a rated Senior Debt Tranche, freely traded. Selected CIF compartments may adopt a two tranche structure if needed to meet investor preferences. All tranches would have maturities equal to the life of the respective CIF compartment, although maturities in the potential third tranche of Senior Debt could be linked to the underlying sovereign bonds acquired by the CIF.
Size of Issuer	The size of each tranche will be determined in the light of take-up from investors in the Participating Tranche and bond investors' appetite for any Senior Debt Tranche.

First Loss Tranche	A first loss tranche will be financed by the EFSF. A coupon of the first loss tranche will be set to cover the all-in funding and related operational costs of the EFSF. The tranche is made available to the CIF after the EFSF enters into a FFA with the relevant Member State and the signing of a MoU specifying conditionality. At maturity of the CIF, or earlier in the case of any sale of underlying bonds, the First Loss tranche will be redeemed from disposal proceeds, after redemption of the capital of any Senior Tranche, the Participating Tranche, but ahead of any gains. The EFSF funding for the First Loss Tranche will be guaranteed by the Member States.
Participating Tranche	A tranche of participating units will be sold to investors; these units will be tradable. The tranche ranks ahead of the First Loss Tranche in any distributions of gains from the CIF, after repaying the capital contribution from both the First Loss Tranche and the capital of the Participating Tranche. The tranche would be funded in pre-agreed drawdowns and any undrawn commitments to be supported by acceptable commitments. It will receive a coupon from the cashflows being generated by the CIF. This may rank in priority to, or after, the coupon due on the First Loss Tranche. The coupon due on any Senior Bond tranche will rank ahead of both these tranches. At maturity of the CIF, or earlier in the case of sales of the underlying bonds, the Participating tranche will be redeemed pro-rata from disposal proceeds, ahead of the First Loss Tranche but prior to distribution of any gains. The majority or all of the gains made on investments at termination of the CIF will be allocated to this tranche, after repayment of all Senior Tranche and EFSF First Loss capital.
Senior Debt Tranche – optional	The CIF can issue rated fixed-income senior bonds, ranking ahead of the Participating Tranche and the First Loss Tranche. The bonds will have a target rating of AA/A dependent on the underlying securities purchased.
Regulatory considerations	The CIF will obtain the necessary regulatory authorization/exemptions within the EU and other jurisdictions where it operates or adopt operational guidelines which ensure compliance with securities and other regulations.