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Fitch Assigns Expected 'AAA' Rating to European Financial Stability Facility (EFSF) Debt Instruments Ratings

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Fitch Ratings-London/Paris-20 September 2010: Fitch Ratings has today assigned expected ratings of 'AAA' to debt instruments issued by the European Financial Stability Facility (EFSF). Final ratings will be assigned at the time of issuance and receipt of final documentation conforming to information already received by Fitch.

The expected 'AAA' rating of EFSF debt instruments is based on the credit enhancement provided by the 'over-guarantee' mechanism and cash reserves. The former allows all Member States, including those rated 'AAA', to provide credit support in an amount greater than their 'contribution key' or share of due amounts and thus partially mitigates the risk of non-payment by other guarantors with a weaker sovereign credit rating. The cash reserves will be sized to ensure that any potential shortfall of 'AAA' guarantor coverage of EFSF debt payments due in the event of a borrower default will be sufficient to meet all payments.

The EFSF is a new supra-national financing vehicle that will be able to raise funds in the market backed by a pool of guarantees from Euro Area Member States (EAMS) to 'on lend' to Members States facing funding difficulties. However unlike traditional supra-nationals it has only notional amounts of paid in capital from its sixteen EAMS shareholders. It is established as a 'societe anonyme' incorporated in Luxembourg, but has a small staff and limited operational capacity. The Board of the EFSF consists of members of the Eurogroup Working Group (senior finance ministry officials from the participating Euro Area Member States). The Chief Executive is Mr. Klaus Regling, a former senior German finance ministry official. It is intended to have temporary life and will be wound-up on 30 June 2013 or thereafter once all loans and debt outstanding have been extinguished.

The term and structure of debt issues by the EFSF would be broadly matched to the profile of its lending and is expected to be eligible collateral for re-purchase transactions with the ECB. Debt issues by the EFSF would be managed on its behalf by the German sovereign debt agency Finanzagentur ('AAA'/Stable). Finanzagentur will also perform treasury and risk management for the EFSF, while the European Investment Bank ('AAA'/Stable) will provide administrative and legal support. Fitch recognises the value of two highly experienced and 'AAA'-rated institutions in minimising potential operational risks that could impair the ability of the EFSF to issue 'AAA'-rated debt instruments.

The EFSF has the potential to issue debt backed by up to EUR440bn of "unconditional and irrevocable" sovereign guarantees (issued under English law), though Greece ('BBB-'/Negative) has 'stepped out' as a guarantor and so the available guarantee pool currently stands at EUR428bn. Debt raised by the EFSF will be 'on-lent' and secured on 'stability support loans' to EAMS in financial difficulties subject to adherence to an economic stabilisation programme agreed with the European Commission acting in liaison with the ECB. The expected 'AAA' rating of EFSF debt instruments is however robust to the potential failure of one or more borrowers to make scheduled repayments. Moreover, the capacity of the EFSF to honour its debt obligations will be sufficient even in the unlikely event that non-'AAA' rated guarantors also fail to meet their share of the guarantee backing. This reflects the large cash reserves that the EFSF will hold and accumulate as it engages in borrowing and lending activities. Consequently the primary potential source of credit and rating transition risk on EFSF debt is if one or more of the largest 'AAA' guarantors were to fail to honour its guarantee commitments or be downgraded. If the latter were to occur, the 'AAA' guarantees plus cash coverage on EFSF debt previously issued could drop below the level consistent with the 'AAA' rating.

When the EFSF extends a loan to a borrower Member State it will charge an up-front Service Fee of 50 basis points on the aggregate principal amount of each loan which will be deducted from the cash amount disbursed to the borrower. In addition, the EFSF will retain from the cash amount of each loan a sum equal to the net present value of the interest margin on the loan from the date of advance to its scheduled maturity date. It is expected that the interest margin will be around 300 basis points based on the precedent set by recent EAMS bilateral loans to Greece. The general cash reserve may be further supplemented by a loan-specific cash buffer to ensure that the share of guarantees from 'AAA' rated EAMS and cash reserves (including 'near-cash' assets) is consistent with the 'AAA' rating of the associated EFSF funding. Cash may be held on account and invested in 'high quality and liquid' securities subject to investment guidelines approved by the Board of Directors of the EFSF.

EFSF debt instruments will be fully backed by 'unconditional and irrevocable' EAMS sovereign guarantees with the share of each determined by its paid-in capital contribution to the ECB ('contribution key'). Each EAMS has undertaken to issue a maximum amount of guarantees, totalling EUR428bn excluding Greece. The EFSF will only become 'financially active' and issue debt if at least one of the remaining fifteen EAMS seeks financial support. In this event the borrowing Member State 'steps out' from being a guarantor (subject to the unanimous agreement of the other EAMS) and the 'contribution key' of remaining guarantors is adjusted upwards on a pro-rata basis to ensure 100% guarantee coverage of subsequent EFSF issues. The 'stepping-out' guarantor would however remain one of the guarantors of any debt previously issued by the EFSF and hence the average credit quality of guarantors could vary across debt instruments. Nonetheless, the loan specific cash buffer would adjust to ensure that the credit quality of EFSF debt instruments is harmonised and consistent with a 'AAA' rating.

If the EFSF becomes aware that it will not receive a scheduled loan repayment that will give rise to a shortfall in available funds to make a scheduled payment of principal or interest on debt issued by EFSF, guarantors will be notified and required to remit to the EFSF their share of such shortfall at least two business days prior to the scheduled payment date. If in addition, one of the guarantors is unable to meet its share, the remaining guarantors' contribution will automatically increase up to 120% of their 'contribution key'.

If and when the EFSF issues debt, final ratings will be assigned to these instruments following receipt of final documentation, including the investment guidelines approved by the Board of Directors of EFSF to manage its associated cash reserves.

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Note for editors: Where a rating is referred to as "expected", this indicates that a full rating has been assigned based upon the agency's expectations regarding final documentation, typically based upon a review of the final draft documentation provided by the issuer. No other conditionality pertains to an expected rating. While expected ratings typically convert to final ratings within a short time, as determined by the issuer's decisions regarding timing of transaction closure, in the period between assignment of an expected rating and a final rating, expected ratings may be raised, lowered or placed on Rating Watch, as with final ratings.

Fitch adopted a bespoke analytical approach addressing the factors outlined in the text above and drawing on elements of the following criteria: 'Sovereign Rating Methodology', dated 13 August 2010 and 'Rating Multilateral Development Banks and Other Supranationals', dated 18 March 2010, which are available at www.fitchratings.com.

Applicable Criteria and Related Research:
Sovereign Rating Methodology
Rating Multilateral Development Banks and Other Supranationals