Interview with Christophe Frankel, CFO and Deputy Managing Director, ESM
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Boersen-Zeitung (BZ): The ESM's refinancing needs have risen substantially compared to what you were expecting at the start of the year, because of the third assistance programme for Greece. How did that alter your refinancing strategy?

Christophe Frankel (CF): The new programme for Greece is a big step for the ESM. Up until now, the ESM had only paid some €40 billion to Spain. Cyprus will get up to €9 billion in the end. But don't forget that the €86 billion in the third programme for Greece through 2018 is an upper limit. So the total could be lower. There are a number of reasons for that. First, we're assuming that the IMF will take part in the financing. Second, Greece's financing needs could drop because of revenues from privatisations. And third, we're confident that Greece will be able to return to markets before the end of the programme in 2018, if the government decisively implements the economic reforms. Reforms in Greece were on the right track until the second half of 2014, and the country was able to successfully issue medium-term bonds twice in 2014.

BZ: In practical terms, what impact does that have on your funding?

CF: We're not expecting to have to finance the total volume of the programme on the markets. That's because we're paying the part of the programme that is earmarked for the recapitalisation of banks – up to €25 billion – in ESM notes. We're creating this paper through a so-called Issue and Repurchase Process, or IRP. Through this process, we've already paid €10 billion in ESM notes into an account that we are managing in Luxembourg. If needed, and under certain conditions, we can add another €15 billion in ESM notes to this purpose. So we're not issuing the resulting €25 billion directly on the markets, but rather over a longer period of several years.

BZ: What's the advantage?

CF: This process enables us to provide Greece with large amounts of money in a very short period of time, without causing major market movements. So we're protecting the value of our bonds, which is positive for investors. Furthermore, the volume that we need to issue on top of that is similar to what we have raised in bond markets in the past. So I have no doubt that we can implement the new programme for Greece smoothly, in the manner you are used to from the ESM.

BZ: How do you make sure that you retain enough flexibility on the market to have sufficient liquidity in your bonds?

CF: The EFSF, the temporary European rescue fund, was created five years ago. The ESM was set up as a permanent institution three years later. Our funding strategy matches the requirements dictated by our capital needs. The ESM has a very well-received programme for short-term money market paper, which enables us to raise liquidity in a short period of time, which we can then transform into longer maturities over time. The third programme for Greece opens up the possibility for the ESM to issue longer maturities than has so far been the case. This increases our flexibility in choosing what type of securities we plan to issue, and helps to increase our investor base. Also, our investors know exactly how we work, because we regularly inform them of the timeframes during which we plan to issue. This makes us transparent, predictable and flexible as an issuer. And we can adapt to market circumstances, not just through volumes, but also timing-wise.

BZ: How does the ESM distinguish itself from other supranational issuers?

CF: In purely technical terms, we're a very specific issuer in the world of supra-nationals. We focus on benchmark issues in euro. We pay a lot of attention to high liquidity for our investors. We've not done any private placements, and we're not yet issuing in currencies other than the euro. That may change in the future, but so far this is our strategy. We also have regular auctions of money market instruments, the bills. This money market paper has a sufficiently high volume. That is also unique in the Supranational, Sub-sovereign and Agencies (SSA) world. These are the instruments that we're using on the market, and that we want to expand further.

BZ: Are you still using the German Finanzagentur to access markets?

CF: We used the funding team of the German Finanzagentur and the German auctions in the initial phase of the EFSF. When the ESM came into existence three years ago, we integrated the funding team in Luxembourg, and expanded it. We're no longer using the German Finanzagentur for our issuance activities. And we're not issuing at the same time as they are, so there are no more overlaps with the Finanzagentur. But it is true that we're still connected to the German Bundesbank because of the ESM bidding system, which we use for our bill and bond auctions.

BZ: How is it that the ESM is in a unique position to explain political as well as funding aspects?

CF: Market participants pay a lot of attention to what we say, because we are very close to the political debate. We're in an interesting position: we're part of the various discussions in the euro area, and at the same time we're very close to the market. This means we're very well able to explain how the institutions in the euro area function, and why certain decisions are taken. So policy becomes easier to understand, and market participants value that. Market participants in or outside Europe often have a hard time understanding the details of a decision, or to read between the lines. That's where we can help. Market participants want to understand how the euro area functions.

BZ: Has the capital of the Member States been paid into the ESM in full?

CF: Yes, the Member States have fully paid in the capital into the ESM. It is just over €80 billion, the highest of all International Financial Institutions worldwide. At first, the amount was exactly €80 billion, but it's gone up a little since Latvia and Lithuania joined monetary union. There are strict guidelines to invest the paid-in capital conservatively, in very secure and very liquid assets. The paid-in capital was provided by taxpayers in the euro area, and we do not use it to lend to programme countries. This is an important point. Other than the €80 billion in paid-in capital, there is also the callable capital, with a volume of €620 billion. So the total available capital is just over €700 billion. In the extreme and very unlikely case that the ESM would default, this capital could become available.

BZ: Does the ESM itself manage the paid-in capital?

CF: Yes, we're doing that internally, with a current team of six portfolio managers. They are subject to very restrictive investment requirements. The primary goal is to conserve capital.

BZ: The European Central Bank (ECB) has been buying bonds since March. In this programme, the ECB can also buy EFSF and ESM bonds. That has caused liquidity to drop in several areas of the bond markets, sometimes dramatically. Is decreasing liquidity a serious issue for you?

CF: We don't get the impression that liquidity in our bonds has dramatically decreased. A number of factors are impacting bonds issued by public institutions, or the SSA sector, over and above the ECB's bond-buying programme. One are the new rules for the banking industry. These are influencing market makers, and investors' access to liquidity. Issuers need to factor this into their funding strategies. This is why we're keeping a very close eye on liquidity in secondary markets. Plus, we're in close contact with market participants, to hear their views and know their problems. We're exchanging information about these issues in several investor groups. But at the moment, I don't see any strong market impact or distortions.

BZ: And what about new issuance premiums?

CF: New issuance premiums, or the spread between a newly issued bond and an existing one in the secondary market, have risen slightly. It's a premium of a few basis points compared to last year. It's not significant. I wouldn't describe the market situation as dramatic.

BZ: Do you expect liquidity to decrease should the ECB continue to expand quantitative easing?

CF: I can't comment on that. As a rule we don't comment on ECB policy. But what I can say is that the way the ECB executed the programme in the market was very smooth. There's a good exchange of information between the ECB and market participants. The ECB is watching markets very closely, and is giving market actors very comprehensive information about the course of the programme.

BZ: What are your investors saying: do they fear a decrease in liquidity, and, as a consequence, more volatile markets?

CF: It's very hard to gauge how this will develop. Regulatory aspects that haven't been fully implemented in the banking sector will impact markets. The bond-buying programme comes on top of that. And then you have to factor in economic aspects and their effect on markets. And there will be activities from some working groups that will affect how markets function. But I don't get the feeling that market participants have much fear over how all of this will pan out.

BZ: Has issuance become harder since the ECB started buying bonds?

CF: Markets adapt to new circumstances, and our funding strategy can react flexibly to investor demand. Our last two bond transactions were a success. They were even more successful than the two deals that we carried out towards the end of 2014 and the beginning of 2015. There are no difficulties. The order books in our past two bond transactions were very large. We haven't seen that in a long time. In our sector, the market continues to function really well.

BZ: Has your issuance activity changed in any other way given these market circumstances?

CF: There've been no big changes. We have always reacted flexibly to investor demands. The new issuance premiums have gone up somewhat. But that makes sense, because the ECB is not allowed to buy bonds in the primary market. That leads to a demand differential between the primary and the secondary market. And that's why new issuance premiums are higher, up to a degree. We're in a low-yield environment, some yields are negative, even. That has an effect. Some investors don't want to invest in bonds with negative yields, or aren't allowed to. But given the good order books for our three-year and our 10-year deals, the conclusion really is that the market is adapting to new circumstances.

BZ: Are you planning any new fixed income instruments? Would you like to issue in other currencies in the near future?

CF: For the near future we have no such plans. Our focus is on liquidity and that means large benchmark deals, along the full yield curve. We will issue longer maturities than was the case in the past. But for the moment, we'll stick with the euro, and euro-denominated bonds.

BZ: What maturity is the longest you want to issue?

CF: We're not quite sure yet. It depends on the maturities needed for the Greek programme, and on what the programme will look like. The final details of the programme haven't been determined, so we don't know the precise maturities. The average maturity in this programme is about 32 years. But the final credit maturities haven't been decided. We could use a bond maturity of 30 years at a later stage. At the moment, the longest maturity at the ESM is 10 years, though the EFSF has already issued bonds with a 30-year maturity. There was no need to use maturities of more than 10 years for the programmes for Spain and Cyprus. But for Greece, we will need longer maturities.

BZ: And what about foreign currency bonds?

CF: For the moment, we will continue to issue in euros. Next year, we will start the technical implementation to issue bonds in other currencies. And in 2017, we'll see if we need to issue bonds in other currencies. We could then issue bonds in other important currencies. But for the moment, we're not planning to.

BZ: Are bonds with a variable rate, so-called floaters, an option for you?

CF: In general, floaters have very low liquidity. Moreover, it's difficult to issue higher volumes in this segment. It's true that the market sometimes goes through phases of high demand for floaters. But we're not getting much requests for this instrument in the current low-yield environment, and with this yield curve. It's an instrument that we could use, generally speaking. But we don't see substantial demand for it at the moment.

BZ: Are private placements an alternative for public benchmark issues for you?

CF: We want to focus on benchmark transactions. We're working on the technical implementation for so-called N-bonds [Namensschuldverschreibungen]. The technical preparations could be ready before the end of this year. We could use this instrument, depending on demand and the market situation. But at the moment we're focusing on public benchmark transactions.

BZ: We've seen a credit rating downgrade for France. Are you calculating at what rating level of the Member States the EFSF and the ESM bonds would lose their Aa-rating?

CF: We're in close contact with the rating agency. They've made clear to us that a further one-notch downgrade for France would not mean that the ESM would lose its double-A status. Obviously, there is a certain relationship between the credit quality of the Member States and that of the ESM. At the same time, the rating agency has made clear that the ESM's system is very solid because of its mission, status, institutional structure, the ample capital framework, the high paid-in capital,and the maximum lending capacity. So there is no direct connection, no one-to-one link, between the rating of the Member States – let alone a single country – and the rating of the ESM.

BZ: What would the consequences be if banks were required to hold equity capital against sovereign bonds, including ESM bonds? Would you be concerned about reduced investor appetite for your bonds?

CF: Many consultations and discussions are currently taking place about this topic. It is an important issue, not only for investors, but also for agencies and supranational issuers. As an issuer, we're aware of the importance of this topic. As far as regulatory measures are concerned, we're in favour for everything that promotes stability. Naturally, you have to take into account we're on the issuing side. But we're seeing that there is a good dialogue between regulators and market participants. For now, we're waiting until this process has come to its conclusion.

BZ : Can you give an indication of your funding needs for next year and until 2020?

CF: At this point in time, we're only disclosing next year's funding volume. For the ESM, it will be €29 billion, and for the EFSF the figure is €14 billion. We know these volumes, and we can get this done in the market. These are funding volumes that we have already seen in the past. The EFSF will be a prominent and, in particular, a frequent issuer in the coming years. It will issue some €25 billion a year. With the new Greek programme, the ESM will raise its presence and also regularly act on the markets. This is good to know for bond investors, given that we will regularly issue large volumes in the coming years. For investors, this means that they will get highly liquid bonds for a reasonably long period of time.