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Working in the ESM mission team to Greece is exceptionally challenging, as we operate under intense pressure and very tight deadlines. There is an immense team effort and commitment by all colleagues to ensure that we achieve success for Greece, which makes this time one of the most rewarding of my professional career.

MIKE HESKETH

Principal Banking Expert

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## ESM cuts interest rate risk for Greece on loans, measures also reduce long-term debt burden

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ESM's short-term measures cut the interest rate risk for Greece on its outstanding ESM and EFSF loans.

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The ESM projects the measures will decrease Greece's debt burden.

The ESM reduced the interest rate risk on Greece's outstanding ESM and EFSF loans by successfully conducting the short-term debt relief measures for Greece in 2017.

Specifically, the ESM estimates that by 2060 the total package will lower the country's debt-to-GDP ratio by about 25 percentage points and the gross financing needs-to-GDP ratio by around six percentage points. The three short-term measures designed and carried out by the ESM consist of: smoothing Greece's repayment profile; reducing interest rate risk; and waiving the step-up interest rate margin for 2017. The euro area finance ministers mandated the ESM to elaborate these measures in May 2016, endorsing the ESM's proposals the following December. Both the ESM and EFSF Board of Directors adopted them the following month. In their May 2016 statement, the finance ministers also mentioned a possible second set of measures, known as medium-term measures, as well as a contingency mechanism to ensure long-run debt sustainability if an adverse economic situation arises.

### Short-term measures

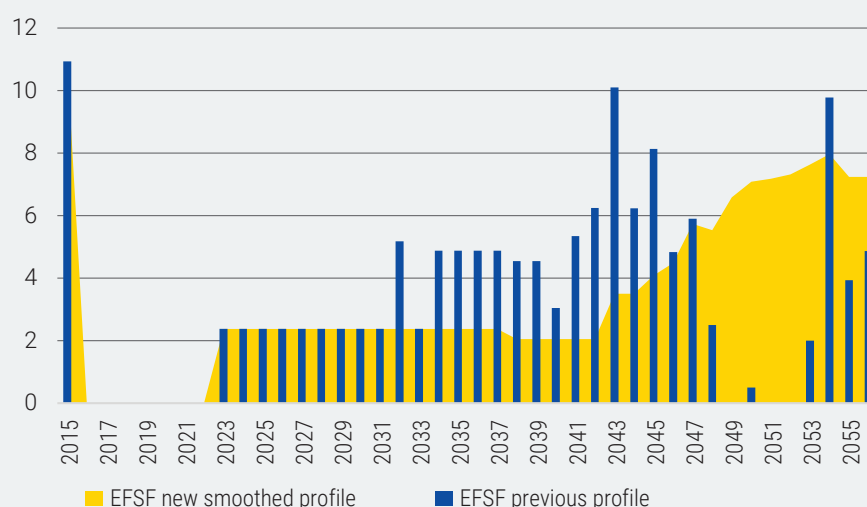
#### Measure 1: Smoothing the EFSF repayment profile under the current weighted average maturity

The maximum weighted average maturity under the EFSF master agreement was set at 32.5 years. But it dropped to about 28 years after Greece returned bonds to the EFSF in February 2015. The maturity has now been brought back to the maximum of 32.5 years, and the repayment schedule has been re-profiled, to avoid a number of repayment humps in the 2030s and 2040s (Figure 15).

Figure 15

**EFSF loans: previous profile vs. new smoothed profile**

(in € billion)



Source: ESM

**Measure 2: Using the EFSF/ESM funding strategy to reduce interest rate risk without incurring any additional costs for former programme countries**

There are three different schemes for the second measure, which focus on locking in the current low interest rates. These bring the largest beneficial effects to Greece in the long term without incurring any additional costs for former programme countries. However, these long-term gains carry some short-term costs.

- **Scheme 1: Bond exchange.** To recapitalise banks, the EFSF/ESM provided loans to Greece worth €42.7 billion during 2012 and 2015. These loans were not disbursed in cash but in the form of floating rate notes. The ESM has now exchanged those notes for cash, funded through long-term fixed-rate funding instruments. This exchange was neutral for Greek banks and needed their consent for implementation. This scheme significantly reduces the interest rate risk that Greece bears.
- **Scheme 2: Swap operations.** The variability of interest rates associated with an ESM loan can be reduced by swapping floating for fixed interest rates. Fixing the interest rate for part of the ESM loan will provide more certainty and predictability on the future stream of interest rates that Greece will pay to the ESM. The ESM put the swap programme in place, and will continue to be active in the derivatives markets to maintain it.
- **Scheme 3: Matched funding.** The ESM can internally allocate the proceeds of long-term issues exclusively to future loan disbursements to Greece. The ESM may continue to use this scheme in 2018, subject to market conditions.

**Measure 3: Waiving the step-up interest rate margin related to the debt buy-back tranche of the second Greek programme for the year 2017**

In December 2012, the EFSF provided €11.3 billion for financing Greece's debt buy-back operations. A margin of 2% had originally been foreseen from 2017 onwards but was not charged for 2017. This constitutes a relief for Greece of around €220 million.

### Impact of the short-term measures

The bond exchange and the interest rate swaps are providing Greece with the most relief.

The short-term measures are seen reducing the overall debt burden by around 10% of GDP.

The short-term debt measures improve Greece's debt sustainability. When implemented in full, these measures should lead to a reduction of Greece's debt-to-GDP ratio of around 25 percentage points until 2060, according to ESM estimates. It is also expected that Greece's gross financing needs will fall by around six percentage points over the same time horizon. The bond exchange and the interest rate swaps make up the largest part of this reduction. Second-round effects on Greece's refinancing rates would be an additional benefit. However, caution is warranted. The impact of some of the measures hinges on several factors beyond the ESM's control. These include the interest rate environment and the availability of other market participants to conclude some transactions.

From a net present value (NPV) perspective, the short-term measures reduce the overall debt burden by around 10% of GDP. The NPV approach consists of discounting the difference between the future cash flows of EFSF and ESM loans before and after the short-term measures. The discount factor reflects the weighted average cost of financing total Greek debt. The NPV gains increase if the second-round effect of lower market refinancing rates for Greece due to the short-term measures is taken into consideration. The eventual aggregate impact of these measures depends, however, on the size and timing of market transactions and the combination of schemes.

