NOMURA

18 October 2011

A Monoline Bazooka?

The EU is due to unveil its draft plan for expanding EFSF resources on 23 October. At present, the EU appears to favour turning the EFSF into a monoline insurer but there may be insuperable treaty problems with this suggestion. Even if the legal hurdles can be overcome, we think a monoline would be an inefficient use of EFSF resources and as such may fall short of the "bazooka" policy response the market is hoping for. Treaty concerns mean that the monoline proposal could morph into a Brady bond proposal.

Fixed Income Research

Contributing Strategists

Desmond Supple
+44 (0) 20 7102 2125
desmond.supple@nomura.com

Nick Firoozye
+44 (0) 20 7103 3611
nikan.firoozye@nomura.com

This report can be accessed electronically via: www.nomura.com/research or on Bloomberg (NOMR)

The timing and shape of the EU plan is becoming clearer

The EU has said that it intends to unveil a framework package of measures aimed at ending the eurozone debt crisis on 23 October. A detailed plan will then be released at the 3-4 November G20 Heads of State meeting.

There is also now greater clarity on the shape of the package. It is likely to entail: (1) a revised private sector involvement (PSI) arrangement for Greece, (2) a plan for bank recapitalisation in the euro area, and (3) most crucially, an expansion of the EFSF's financial resources, with the EU seeming to favour an approach that leverages the EFSF by transforming it into a monoline insurer.

While this combination of policies is preferable to the status quo, they would likely fall short of what could be defined as a "bazooka" that is capable of altering the current asymmetric risk-reward profile in European markets and hence altering asset allocation decisions. Our interest rate strategy team is positioning for market disappointment and sees value in trades such as buying out-of-the-money Schatz calls (see *European Rates Weekly*, 14 October 2011).

Assuming – for now – the EU does not delay until ESM replaces EFSF

It is worth noting that turning EFSF 2.0 into a monoline insurer (EFSF 3.0) would require a new framework that would once again have to be approved by all 17 euro-area countries. Some policymakers have proposed bringing forward the launch of the EFSF's successor, ESM from summer 2013 to mid-2012, since this institution will be able to issue insurance. This is because the ESM will be a far more flexible institution. The obvious downside of this scenario is that it would incur a long delay, which would be problematic in the context of the current EU debt crisis where the market expects a more immediate solution. The earliest that we think the ESM could realistically be implemented is mid-2012, or nine months away.

A second problem with EU politicians waiting for the ESM to be implemented is that this institution can only enter into force if the Treaty on the Functioning of the European Union has been amended. This requires approval from each the 27 EU states, so in principle there is a single-country veto. It is unclear what the approval procedure would entail within each country. In the past, treaty amendments could only be approved if there was a two-thirds majority in parliament by presence of a least half the members (e.g. in Austria). In other countries, the process required holding a referendum (e.g. Ireland and Denmark). Since 10 out of the 27 countries will not be part of the ESM, these countries are unlikely to veto the treaty amendments. But getting the treaty amendments approved by the 17 parliaments of the euro area may prove even more challenging than getting the EFSF 2.0 bill through the same parliaments.

For simplicity, the analysis below assumes that the EU does not wrap a monoline plan into an accelerated timeframe for implementing the ESM. If this assumption proves false, then our response to the EU plan would likely be even more pessimistic since a long delay before a policy response was in place would raise the risk of dual equilibrium events occurring in markets if, for instance, the ECB's willingness to support bond markets via its SMP was exceeded over the subsequent nine months.

The monoline proposal for the EFSF 3.0

As noted above, we think the degree to which the EU can allocate additional financial resources to the debt crisis will be key to the eventual success of any package. Comments from this weekend's G20 meeting suggested that the EU would seek to leverage the existing EFSF 2.0 via transforming this into a monoline insurer, and hopes have again been raised that this proposal could deliver a pool of resources close to EUR2trn.

What is a monoline insurer?

In the context of the EU proposal, a monoline insurer is simply a financial institution which facilitates the transfer of credit risk by providing default insurance on the liabilities of a third party. A monoline insurer typically focuses on a very narrow scope of business, in this case bond issuance. In the event of a company defaulting on its debt, bond holders should be repaid in full or in part (depending on the nature of the insurance contract) by the monoline insurer. A monoline insurance, or credit wrap, can result in a rating upgrade for the insured debt instrument relative to the non-insured loans, if and only if there is sufficient confidence in the ability of the insurer to meet its liabilities in a default event.

Details of the monoline proposal

It currently appears that the unallocated capital of the EFSF will be used to write a first loss protection on newly issued bonds from selected EU countries that are deemed to have a liquidity problem rather than a solvency problem. It is widely expected that the insurance could cover a first loss of 20-30%, but of course the insurance could cover a second loss tranche or a portion of overall losses. No further details are available, but one key area of uncertainty is whether the insurance would be transferable between holders of the debt. The simplest outcome would be to wrap the insurance into a new bond issue but, as we discuss below, this would lead to a permanent use of bail-out funds (or at least for the full maturity of the credit-wrapped debt instrument) that could be illegal under the EU Treaty. Alternatively, the EFSF could issue insurance to individual holders of a bond, but this would be problematic as the first loss indemnity would not be transferable between holders.

Positive aspects of the monoline proposal

On a positive note, the monoline scenario provides a potential avenue through which the EFSF’s resources could be leveraged. If the EU were to deliver a package of measures that included a "durable" solution for Greece, a EUR200bn plan for recapitalising European banks and a plan for the EFSF to leverage its capital by becoming a monoline, many investors could view this as being sufficient to comprise a “bazooka”. Indeed, the market's recent positive bias clearly suggests that more investors are seeing events in these terms, even if short- covering rather than a change in investor asset allocation strategy is driving price action in European fixed income.

A second positive aspect of the monoline proposal is that it is extremely flexible. The insurance could be bespoke and tailored to individual issuers or buyers of bonds. For instance, while the most likely focus of monoline insurance is embedding a credit wrap into a newly issued bond, it is possible that the EFSF could indemnify existing holdings of bonds for banks only. This proposal would be more complex than credit wrapping a new issue and would raise questions as to whether the insurance could be transferable when a bond was sold, but it would effectively create a pool of assets within a bank that would be ring-fenced from the rest of a bank’s portfolio. The benefit to a bank would be less mark-to-market losses and potentially less pressure on capital ratios for this pool of insured bonds.

However, below we list the factors that leave us concerned that the impact of a monoline proposal could be less than the market anticipates. (For our original analysis of the impact of a monoline proposal for the EFSF see our strategy note, *EFSF 2.0, 3.0 and beyond*, 29 September 2011).

Caveat #1 – Inefficient use of EFSF resources…

If the EFSF is to provide a first loss guarantee to the market, then in our view it will need to be an AAA-rated entity. This would mean the EFSF only being able to utilise its EUR440bn worth of over-collateralised usable/investible funds, rather than its EUR726bn in guarantees. This is important since we assume that the EFSF's available pool of usable resources is lowered by its EUR147bn in commitments to the financial packages for Greece (assuming that the EFSF's financial commitments for PSI 2.0 are the same as those for PSI 1.0), Portugal and Ireland, and up to EUR200bn that will be allocated to bank recapitalisation, although to be generous we assume that EUR100bn of these funds will be provided by AAA countries directly to their banking systems. This would leave around EUR200bn in usable resources. Leveraging the EFSF up to a EUR2trn pool of funds would therefore entail the provision of only a 10% first loss indemnity which would probably be too small. A 20% first loss insurance would entail leveraging to EUR1trn.

…correlation risk…

An additional risk of this proposal is that it crucially relies on key countries in Europe retaining their AAA rating. Were a country such as France to lose its AAA status, then the need to retain an AAA rating on the EFSF monoline would require French guarantees being allocated among the remaining AAA countries, which carries obvious political risks. The correlation risk is non-negligible since the credit worthiness of AAA countries is sensitive to the travails in peripheral and semi-core euro area. The poor performance of the EFSF debt in recent weeks – as the market has considered the risk of a downgrade to a European AAA country and as discussions have intensified about changing the nature of the EFSF – highlights the possibility that the market might not have full faith in the strength of an EFSF first loss guarantee. Moreover, the experience of the early phases of the financial crisis shows that monoline structures can add to systemic risk if their credit-wrapping facilitates a marked expansion of debt issuance but the correlation risk implicit in many monoline insurers subsequently means that the institution itself starts to get downgraded.

…and the need for additional resources

Were the EFSF to be leveraged to EUR2trn without the first loss insurance being lowered to 10%, additional funds may be required. The allocation of an additional EUR200bn in IMF funds, for instance, could allow for the EUR2trn figure to be reached at a 20% first loss level. Encouragingly, the IMF and G20 have not ruled out the provision of such funds, but any such investment would be contingent on the IMF being confident that a viable plan exists. Moreover, the market thinks that the UK and US may balk at an IMF contribution in excess of EUR70bn.

Caveat #2 – Balance sheet and deleveraging

As banks focus on bolstering capital ratios, they are looking to scale back balance sheets particularly in areas where a credit or market risk component of their investments is unusually high. A partial EFSF monoline credit wrap would risk facilitating rather than reversing this process of deleveraging by providing assets with a lower credit risk to which banks could allocate funds, while at the same time seeking to scale back exposure elsewhere. In this respect, there is a risk that the expansion in the asset base of the banking system in Europe could be far less than the value of the increased investible assets of a leveraged EFSF.

Caveat #3 – two-tier bond markets

The above point could also result in the generation of two-tier bond markets. Legacy debt would – under the most likely monoline scenarios – not carry a credit wrapper, and demand for these assets could diminish as investors instead favoured credit-wrapped new issues. Of course, by reducing forthcoming financing risks, some of the risk premium associated with legacy debt would diminish, but clearly investors would see legacy debt as lying further down the capital structure than EFSF-wrapped debt.

While the subordination of legacy debt in Europe in the event of EFSF becoming a monoline would not be explicit – or else it would trigger a CDS event – the perception of a lower recovery rate on legacy debt in the event of a default could nonetheless limit demand for these securities. (We would term the seniority of credit wrapped bonds over legacy debt as being *de facto* rather than *de jure*. This is important since there are already many examples of *de facto* senior bonds that do not trigger CDS such as the IMF loans, the bilateral loans for Greece, the EFSF loans to Ireland and Portugal and all foreign law bonds throughout Europe.)

Caveat #4 – Semi-core focus only

The monoline proposal could only realistically be applied to countries where the market is comfortable about the underlying solvency of the issuer. This means that the monoline solution is only applicable at present to semi-core countries, and cannot be a solution for the peripheral countries. This is because a country facing solvency concerns would find the cost of insuring its bonds prohibitive (or if the insurance contract was to be provided to the buyer of a bond, then the insurance premium would be extremely expensive].

Caveat #5 – Legal/practical issues

The EFSF is unable to issue insurance in its current form. A change to its structure would require approval by all 17 national parliaments. In addition, the provision of insurance would by definition not be a temporary arrangement since it would need to persist for the life of an insurance contract. This could contravene Article 125 of the EU Treaty.

An argument could be made that a permanent bail-out facility of this nature could be allowed under Article 122 which allows for Article 125 to be superseded under conditions which are defined as "exceptional circumstances". However, in March 2010 Angela Merkel stated that exceptional circumstances "are rather earthquakes and floods, but also natural catastrophes, than something that can be applied to the Greek situation."

As stated above, the EU may try to link the creation of a monoline insurer to the implementation of ESM. However, given that the earliest that we could realistically see the ESM being implemented is mid-2012, the near-term implication would be adverse for market sentiment since hopes have been raised for a more immediate solution.

Caveat #6 – Conditionality

Designing a bond insurance scheme is one challenge. Ensuring that the bond insurance scheme is only used under very strict conditionality is another challenge. So far, the assistance provided to Greece, Portugal and Ireland has been conditional upon these countries adopting an IMF/EU/ECB macroeconomic adjustment programme that involves a combination of structural reform measures, and financial sector and fiscal adjustment.

Any bond insurance scheme would probably be intended for Italy and Spain. But both countries are deemed too large for a formal IMF/EU/ECB programme. The question is whether the bond insurance scheme can be designed such that moral hazard is minimised. While the issuance of fresh Bradys for Italy could be similarly linked to conditionality, there are currently no plans to establish an appropriate monitoring body with the authority to suspend a Brady issuance programme at short notice.

Monoline likely to fall short of a “bazooka” policy response

Given the above factors, we do not believe that transforming the EFSF into a monoline insurer can bring us to a steady state solution of the Euro crisis. We continue to seek a balance sheet capable of absorbing increased credit risk, which ultimately relies on either the ECB being willing to support a marked expansion of its balance sheet or AAA governments acceding to create fiscal integration and hence a threat to their balance sheets. The monoline situation crucially relies on the balance sheets of financial institutions warehousing credit risk, albeit with a finite amount of fiscal resources aimed at funding a partial indemnity. The proposal would be better than nothing, but we do not believe it would be sufficient to create a "bazooka" sufficient to alter the asymmetry in the market and generate a change in asset allocation decisions. (We discussed in detail the role of the ECB in the current crisis in our economic research note, *EFSF 3.0 and the fate of the ECB's SMP*, 10 October 2011). As such, we fear that the market's expectations may be disappointed if the EU policy package for addressing the eurozone crisis has at its core a monoline proposal.

A Brady bond solution may be more practical than turning the EFSF into a monoline

On a related note, over the coming weeks, the focus on turning the EFSF into a monoline insurer could morph into a discussion of using the EFSF to issue Brady bonds (see *EFSF 2.0, 3.0 and beyond*, 29 September 2011).

Unlike insurance, EFSF 2.0 can offer Brady-style products without the need for further ratifications. In terms of technical implementation, a Brady can be seen to be economically equivalent to a first loss insurance, while a collateralised escrow account can be structured to mimic various forms of insurance, albeit with larger set-up costs. Each of these large-scale insurance options can be used to insure all new issue at the risk of forcing a two-tier bond market. It is notable, in our view, than when the various options for the Greek PSI 1.0 were unveiled, the EU eschewed insurance-based options in favour of Brady bond-type collateral underpinning the debt swaps (see link).

If, however, the more individual non-transferable insurance for banks is the approach chosen, this can be structured entirely through similar escrow accounts but through a repackaging (i.e. a bankruptcy remote multi-issuer SPV) solution. In all cases they can be made economically equivalent to the insurance from the bond-holder's point of view, although from the sovereigns' and EFSF's point of view, Brady-style solutions and insurance/guarantees are typically significantly different. For instance, should monoline insurance be the chosen path, were a country to default it would incur no additional liabilities as the insurer would assume the costs of its indemnity, whether this be full or partial. However, in the case of a country defaulting when it has issued Brady bonds, the liability was already pre-issued when the Brady bond was initiated. As such, the Brady bond scenario is less attractive for debt issuers than the monoline situation.

Downsides to Brady bonds are similar to monoline downsides

One downside of being economically equivalent to credit-wrapped bonds is that many of the drawbacks of the monoline proposal also apply to this option. In particular, Brady bonds help slow deleveraging rather than encourage releveraging, and there is also a problem of a two-tier market. For instance, in order to leverage the EFSF's capital base effectively, Brady issuance would need to be long dated, since the PV of the guaranteed principal would be accounted for when considering the capacity of the EFSF 2.0, and the longer dated the instrument the lower the PV and hence the greater the EFSF would be able to leverage its resources. A situation could emerge where the Brady bond solution would focus on providing 30yr Brady bond issuance in a country such as Italy, while one can argue that optimally the EFSF should be issuing extremely long-dated bonds such as 50-100 years. On one level, the issuance of long-dated securities may make it difficult for the euro area to claim that its mechanisms are temporary in nature, and hence while the EFSF 2.0 can issue Bradys there may be a risk of long-dated issuance contravening the treaty. More practically, there remains the risk of Brady issuance crowding out non-Brady issuance in particular parts of the curve.

DISCLOSURE APPENDIX A1

ANALYST CERTIFICATIONS

We, Desmond Supple, Nick Firoozye and Jens Sondergaard, hereby certify (1) that the views expressed in this report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this report, (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report and (3) no part of our compensation is tied to any specific investment banking transactions performed by Nomura Securities International, Inc., Nomura International plc or any other Nomura Group company.

Issuer Specific Regulatory Disclosures

Mentioned companies

Issuer name	Disclosures
GOVERNMENT OF PORTUGAL	11
Hellenic Republic	11
Republic of Italy	11

Disclosures required in the European Union

11 **Liquidity provider**
Nomura International plc and/or its affiliates (collectively "Nomura") is a primary dealer and/or liquidity provider in European, United States and Japanese government bonds. As such, Nomura will generally always hold positions in these bonds, which from time to time, may be considered a significant financial interest.

IMPORTANT DISCLOSURES

Online availability of research and additional conflict-of-interest disclosures

Nomura Japanese Equity Research is available electronically for clients in the US on NOMURA.COM, REUTERS, BLOOMBERG and THOMSON ONE ANALYTICS. For clients in Europe, Japan and elsewhere in Asia it is available on NOMURA.COM, REUTERS and BLOOMBERG.
Important disclosures may be accessed through the left hand side of the Nomura Disclosure web page http://www.nomura.com/research or requested from Nomura Securities International, Inc., on 1-877-865-5752. If you have any difficulties with the website, please email grpsupport-eu@nomura.com for technical assistance.
The analysts responsible for preparing this report have received compensation based upon various factors including the firm's total revenues, a portion of which is generated by Investment Banking activities.
Unless otherwise noted, the non-US analysts listed at the front of this report are not registered/qualified as research analysts under FINRA/NYSE rules, may not be associated persons of NSI, and may not be subject to FINRA Rule 2711 and NYSE Rule 472 restrictions on communications with covered companies, public appearances, and trading securities held by a research analyst account.

ADDITIONAL DISCLOSURES REQUIRED IN THE U.S.

Principal Trading: Nomura Securities International, Inc and its affiliates will usually trade as principal in the fixed income securities (or in related derivatives) that are the subject of this research report. Analyst Interactions with other Nomura Securities International, Inc Personnel: The fixed income research analysts of Nomura Securities International, Inc and its affiliates regularly interact with sales and trading desk personnel in connection with obtaining liquidity and pricing information for their respective coverage universe.

Valuation Methodology - Global Strategy

A “Relative Value” based recommendation is the principal approach used by Nomura’s Fixed Income Strategists / Analysts when they make “Buy” (Long) “Hold” and “Sell” (Short) recommendations to clients. These recommendations use a valuation methodology that identifies relative value based on:
a) Opportunistic spread differences between the appropriate benchmark and the security or the financial instrument,
b) Divergence between a country’s underlying macro or micro-economic fundamentals and its currency’s value and
c) Technical factors such as supply and demand flows in the market that may temporarily distort valuations when compared to an equilibrium priced solely on fundamental factors.
In addition, a “Buy” (Long) or “Sell” (Short) recommendation on an individual security or financial instrument is intended to convey Nomura’s belief that the price/spread on the security in question is expected to outperform (underperform) similarly structured securities over a three to twelve-month time period. This outperformance (underperformance) can be the result of several factors, including but not limited to: credit fundamentals, macro/micro economic factors, unexpected trading activity or an unexpected upgrade (downgrade) by a major rating agency.

DISCLAIMERS

This publication contains material that has been prepared by the Nomura entity identified at the top or bottom of page 1 herein, if any, and/or, with the sole or joint contributions of one or more Nomura entities whose employees and their respective affiliations are specified on page 1 herein or elsewhere identified in the publication. Affiliates and subsidiaries of Nomura Holdings, Inc. (collectively, the 'Nomura Group'), include: Nomura Securities Co., Ltd. ('NSC') Tokyo, Japan; Nomura International plc ('NIplc'), United Kingdom; Nomura Securities International, Inc. ('NSI'), New York, NY; Nomura International (Hong Kong) Ltd. (‘NIHK’), Hong Kong; Nomura Financial Investment (Korea) Co., Ltd. (‘NFIK’), Korea (Information on Nomura analysts registered with the Korea Financial Investment Association ('KOFIA') can be found on the KOFIA Intranet at http://dis.kofia.or.kr); Nomura Singapore Ltd. (‘NSL’), Singapore (Registration number 197201440E, regulated by the Monetary Authority of Singapore); Capital Nomura Securities Public Company Limited (‘CNS’), Thailand; Nomura Australia Ltd. (‘NAL’), Australia (ABN 48 003 032 513), regulated by the Australian Securities and Investment Commission ('ASIC') and holder of an Australian financial services licence number 246412; P.T. Nomura Indonesia (‘PTNI’), Indonesia; Nomura Securities Malaysia Sdn. Bhd. (‘NSM’), Malaysia; Nomura International (Hong Kong) Ltd., Taipei Branch (‘NITB’), Taiwan; Nomura Financial Advisory and Securities (India) Private Limited (‘NFASL’), Mumbai, India (Registered Address: Ceejay House, Level 11, Plot F, Shivsagar Estate, Dr. Annie Besant Road, Worli, Mumbai- 400 018, India; SEBI Registration No: BSE INB011299030, NSE INB231299034, INF231299034, INE 231299034); Banque Nomura France (‘BNF’); NIplc, Dubai Branch (‘NIplc, Dubai’); NIplc, Madrid Branch (‘NIplc, Madrid’) and OOO Nomura, Moscow (‘OOO Nomura’).
THIS MATERIAL IS: (I) FOR YOUR PRIVATE INFORMATION, AND WE ARE NOT SOLICITING ANY ACTION BASED UPON IT; (II) NOT TO BE CONSTRUED AS AN OFFER TO SELL OR A SOLICITATION OF AN OFFER TO BUY ANY SECURITY IN ANY JURISDICTION

Additional information available upon request.

NIPlc and other Nomura Group entities manage conflicts identified through the following: their Chinese Wall, confidentiality and independence policies, maintenance of a Stop List and a Watch List, personal account dealing rules, policies and procedures for managing conflicts of interest arising from the allocation and pricing of securities and impartial investment research and disclosure to clients via client documentation.

Disclosure information is available at the Nomura Disclosure web page:

http://www.nomura.com/research/pages/disclosures/disclosures.aspx

Nomura International plc Tel: +44 20 7102 1000
1 Angel Lane, London EC4R 3AB