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ESM FUND – THE CRACKS
EUROZONE SOLUTION

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Mike Nawas of *Bishopsfield Capital Partners*, working with Dennis Vink of Nyenrode University in the Netherlands, has looked at ways to boost the eurozone's rescue fund capacity, proposing that policy-makers explore structured finance techniques to bring in outside capital.

Their idea is that the ESM provide a first-loss for any eurozone rescue, providing enough credit support to attract a G20 or IMF package at a senior level. Ideas discussed last year included giving EFSF a banking licence or tranching the rescue fund itself, but floundered as EFSF CEO Klaus Regling wrote an open letter to emphasise the equality of investors in the EFSF.

"Rather than time-subordination, as was discussed last year, our idea is to make the ESM explicitly bear the first loss in eurozone rescue packages," said Vink. "With this credit support, the ESM could attract investment from surplus countries in a senior tranche, boosting rescue funds to a level where the market could have real confidence in the fund capacity."

Deliberately creating a tranched structure would also offer a way to partly depoliticise eurozone rescue packages. The contracts governing the structure would set creditor rights and responsibilities, rather than making them dependent on political wrangling within the eurozone.

Nawas added: "Tranching would also help deal with eurozone anxieties about involving outside parties. The subordinated risk holders would have more control rights, in return for bearing more risk. Bringing in G20 or IMF funds at a senior level would allow capital to come in without surrendering too much control over the rescue process."

Any such fund would have to overcome formidable challenges even if political will could be found, though. A contractual system, based on structured finance technology, would need a governing law – and it would be an open question whether sovereigns with investment capacity like China would depend on New York or English law to enforce its creditor rights in such a high-profile investment.

Some sort of trustee role would also be necessary, which would need a body like the IMF to safeguard the rights and responsibilities of creditors.