European Stability Mechanism

October 2012

European Stability Mechanism

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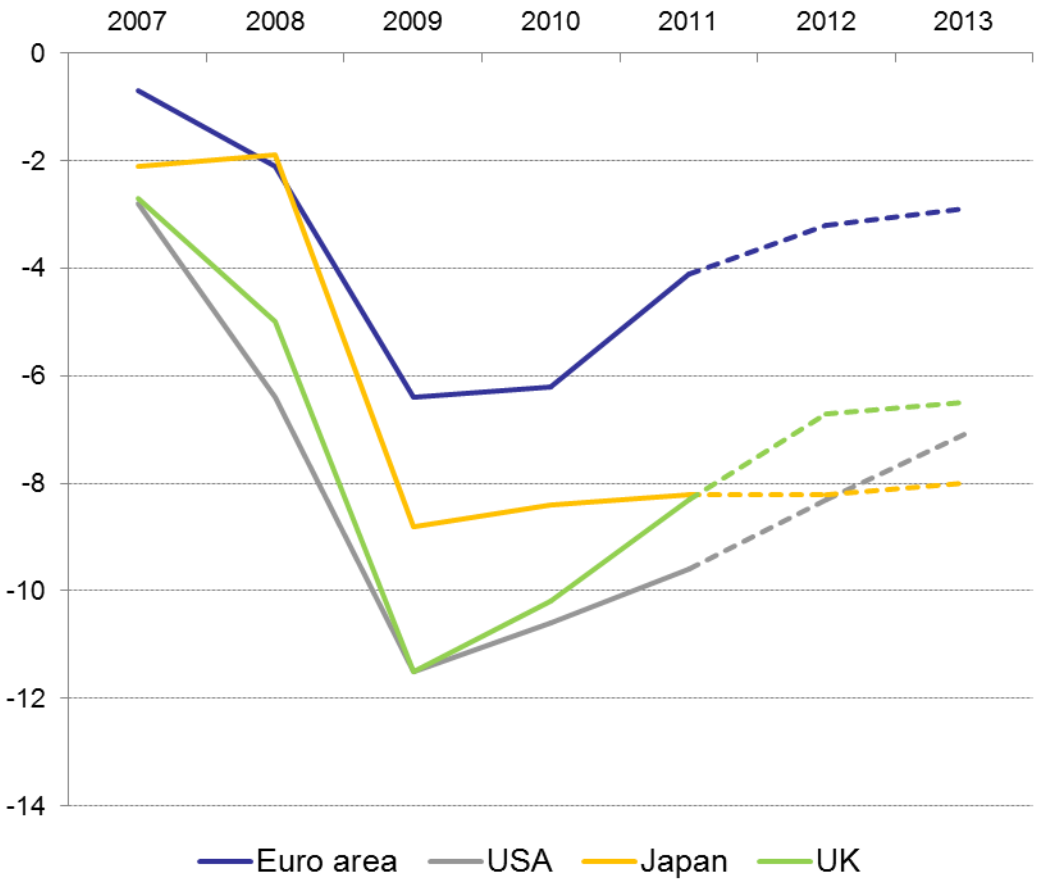
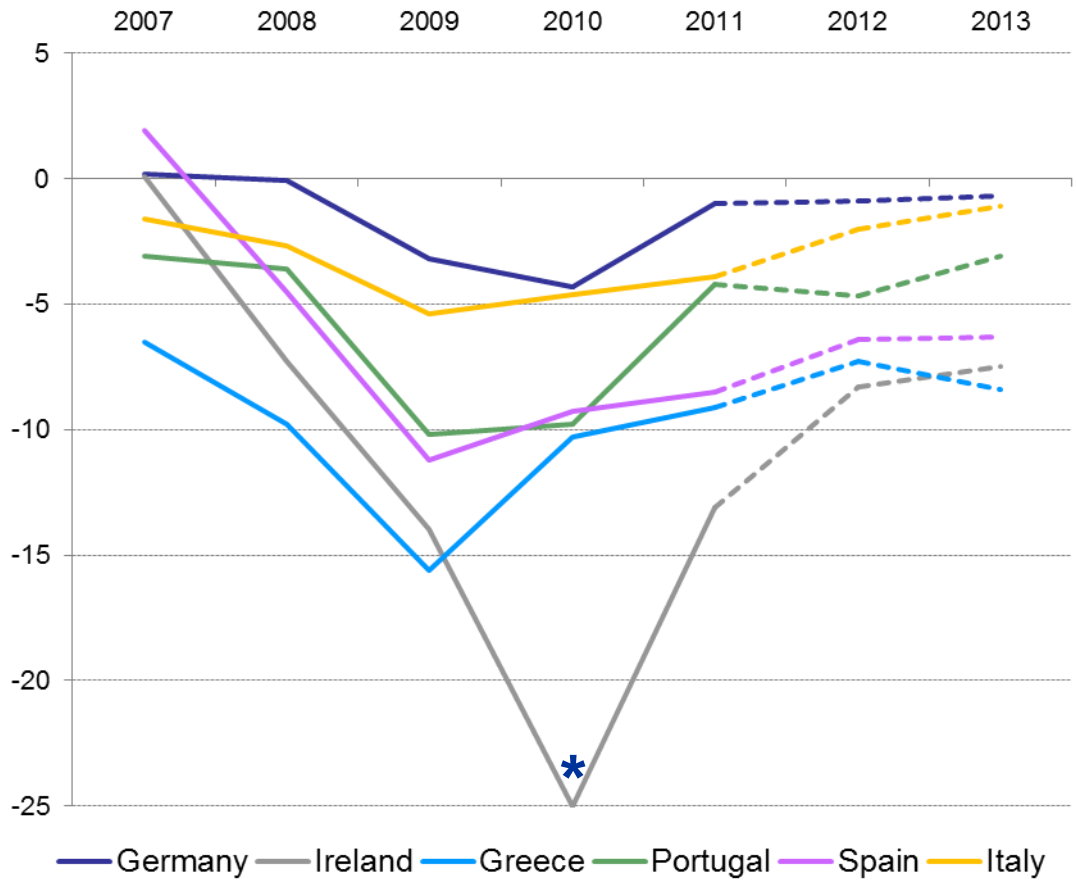
European strategy is delivering results - fiscal

Fiscal balance, Euro area vs USA and Japan (as % of GDP)



Fiscal balance, euro area Member States (as % of GDP)



Source: European Commission, European Economic Forecast – Spring 2012

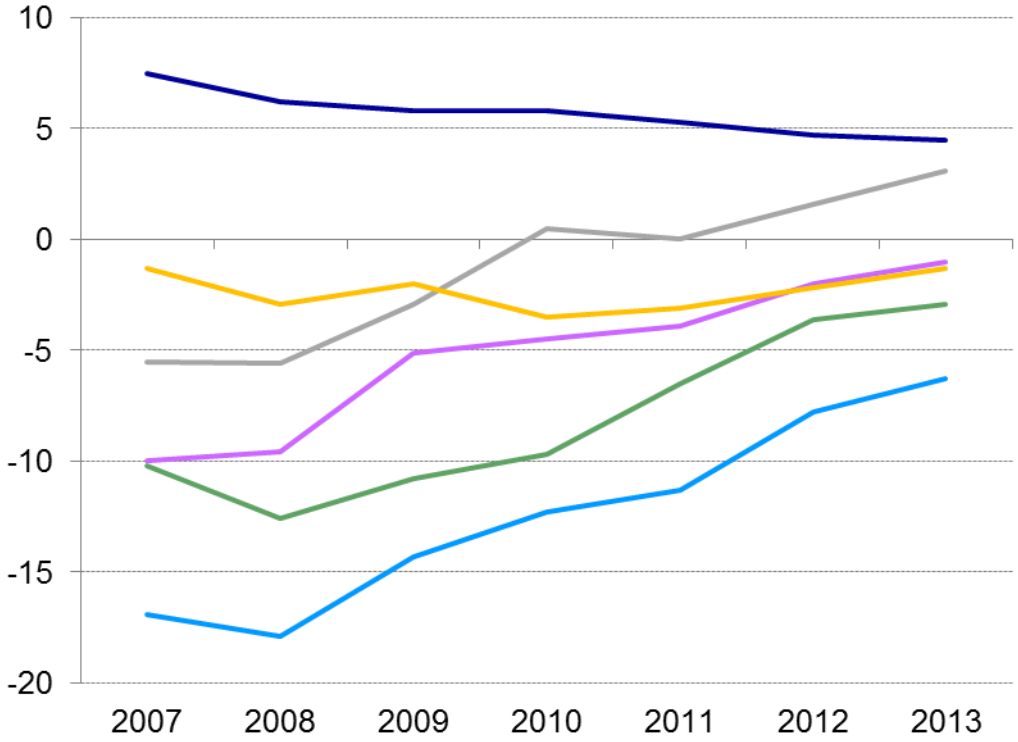
* Actual figure for Ireland 2010 -31.2%

European Stability Mechanism

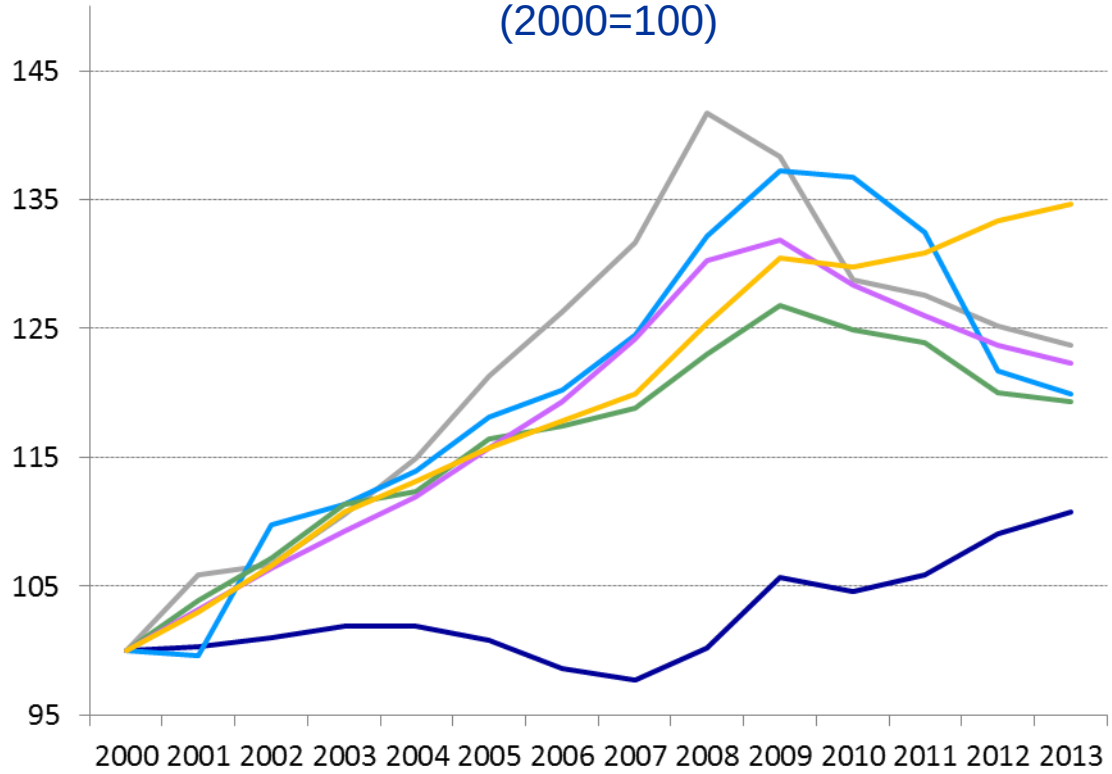
European strategy is delivering results - competitiveness

- Divergences within EMU are declining
- Competitiveness is improving in all Southern European countries

Current Account Balance (as % of GDP)



Nominal unit labour costs, whole economy (2000=100)



Germany Ireland Greece
Portugal Spain Italy

Source: Eurostat, EC European Economic Forecast Spring 2012

European Stability Mechanism

Better fiscal consolidation and a new model of economic governance

- Reinforcing the **Stability and Growth Pact**
  - Automatic consequences if 3% deficit ceiling is breached
  - More emphasis given to debt criterion
  - “Reversed” voting in Council eliminates possibility for political interference

- New **“Fiscal Compact”**
  - Annual structural public deficit shall not exceed 0.5% of nominal GDP
  - Balanced budget rule to be introduced in national legal systems
  - Reinforced surveillance and coordination of economic policies
  - European Court of Justice monitors implementation

- New **”Macroeconomic Imbalance Procedure”**
  - Based on scoreboard of indicators
  - Internal imbalances: e.g. arising from public and private indebtedness
  - If excessive imbalance: Corrective Action Plan from MS and recommendation from Commission

- **“European Semester”:** yearly cycle of economic and fiscal policy coordination
  - Country-specific recommendations; priorities include growth-friendly fiscal consolidation
  - New focus: avoid “spill-overs”

Better fiscal consolidation and a new model of economic governance

- **"Euro-Plus Pact"**
  - National measures to foster competitiveness, employment, sustainability of public finances, and reinforce financial stability
- Comprehensive **regulatory reform agenda** for financial markets
  - Implementation of Basel III (CRR Regulation and CRD IV Directive)
- New European institutions for financial market supervision
  - Three new supervisory authorities – **EBA**, **EIOPA**, **ESMA** – oversee EU banking, insurance & securities markets
  - A European Systemic Risk Board (**ESRB**) to monitor macro-prudential risks
- More efficient **decision-making process** among euro area countries
  - Strengthening the Eurogroup workstream
  - Formalisation of Euro Area Summit
- **New institutions for crisis management** – EFSF (since 2010) and ESM (inaugurated on 8 October 2012)

Determined and coordinated action to safeguard financial stability

2010	**7 June**	***European Financial Stability Facility (EFSF)*** was created
	28 November	Agreement of financial assistance programme for Ireland (€85 billion)
2011	**17 May**	Agreement of financial assistance programme for Portugal (€78 billion)
	20 June	Agreement by euro zone and EU finance ministers to increase EFSF effective lending capacity, widen scope of mandate and finalise terms of permanent stability mechanism, European Stability Mechanism
	21 July	Euro zone summit, second support package for Greece and increased scope for EFSF/ESM
	9 December	EU summit – ESM brought forward, EFSF will continue as scheduled until end June 2013
2012	**2 February**	ESM treaty signed
	14 March	Second Greek programme formally approved by Euro Working Group
	30 March	Eurogroup decides on EFSF/ESM to run in parallel
	20 July	Eurogroup grants financial assistance to Spain's banking sector
	8 October	**ESM inaugurated**

European Stability Mechanism

ESM : the permanent crisis mechanism for the euro area

- an intergovernmental organisation under public international law
- effective lending capacity of €500 billion
- total subscribed capital of €700 billion, with paid-in capital (€80 billion) and committed callable capital (€620 billion)
- Following established IMF policies regarding private sector involvement
  - ESM will claim preferred creditor status (except for existing facilities at the signing of the ESM treaty and the financial assistance for the recapitalisation of Spanish financial institutions)

EFSF and ESM: mission and scope of activity

Mission : to safeguard financial stability in Europe by providing financial assistance to euro area Member States

Instruments

- ***Loans***
- ***Primary Market Purchases***
- ***Secondary Market Purchases***
- ***Precautionary Programme***
- ***Bank recapitalisations through loans to governments****

All assistance is linked to appropriate conditionality

EFSF and ESM finance their activity by issuing bonds or other debt instruments

* Including in non programme countries

EFSF & ESM: differences

	European Financial Stability Facility	European Stability Mechanism
Legal Structure	Private company under Luxembourg law	Inter-governmental institution under international law
Duration	Temporary (June 2010-June 2013)	Permanent institution
Capital structure	Backed by guarantees of euro area Member States	Subscribed capital of €700 billion €80 billion in paid-in capital €620 in committed callable capital
Guarantee Structure	Member States under a programme «step out» of guarantee structure	ESM Members do not «step out»
Maximum Lending capacity	€440 billion	€500 billion
Claims to loans	Pari passu	Preferred creditor status *

* For the financial assistance for recapitalisation of the Spanish banking sector, pari passu will apply

ESM shareholder contributions

Member States	Credit rating (S&P/Moodys/Fitch)	ESM contribution key (%)	Capital subscription (€bn)	Paid-in capital (€bn)
Austria	**(AA+/Aaa/AAA)**	**2.7834**	**19. 48**	**2.22**
Belgium	(AA/Aa3/AA)	3.4771	24. 34	2.77
Cyprus	(BB/B3/BB+)	0.1962	1.37	0.16
Estonia	(AA-/A1/A+)	0.1860	1.30	0.15
Finland	**(AAA/Aaa/AAA)**	**1.7974**	**12. 580**	**1.43**
France	**(AA+/Aaa/AAA)**	**20.3859**	**142.70**	**16.27**
Germany	**(AAA/Aaa/AAA**	**27.1464**	**190.02**	**21.66**
Greece	(CCC/C/CCC)	2.8167	19.71	2.25
Ireland	(BBB+/Ba1/BBB+)	1.5922	11.14	1.27
Italy	(BBB+/Baa2/A-)	17.9137	125.39	14.29
Luxembourg	**(AAA/Aaa/AAA)**	**0.2504**	**1.75**	**0.20**
Malta	(A-/A3/A+)	0.0731	0.51	0.06
Netherlands	**(AAA/Aaa/AAA)**	**5.7170**	**40.02**	**4.56**
Portugal	(BB/Ba3/BB+)	2.5092	17.56	2.00
Slovakia	(A/A2/A+)	0.8240	5.77	0.66
Slovenia	(A/Baa2/A-)	0.4276	2.99	0.34
Spain	(BBB-/Baa3/BBB)	11.9037	83.32	9.50
Total		**100%**	**700.00**	**80.00**

Robust Capital Structure and Strong Shareholder Commitment

Paid-in capital €80 billion

Committed callable capital €620 billion

ESM's subscribed capital exceeds maximum lending capacity by 40%

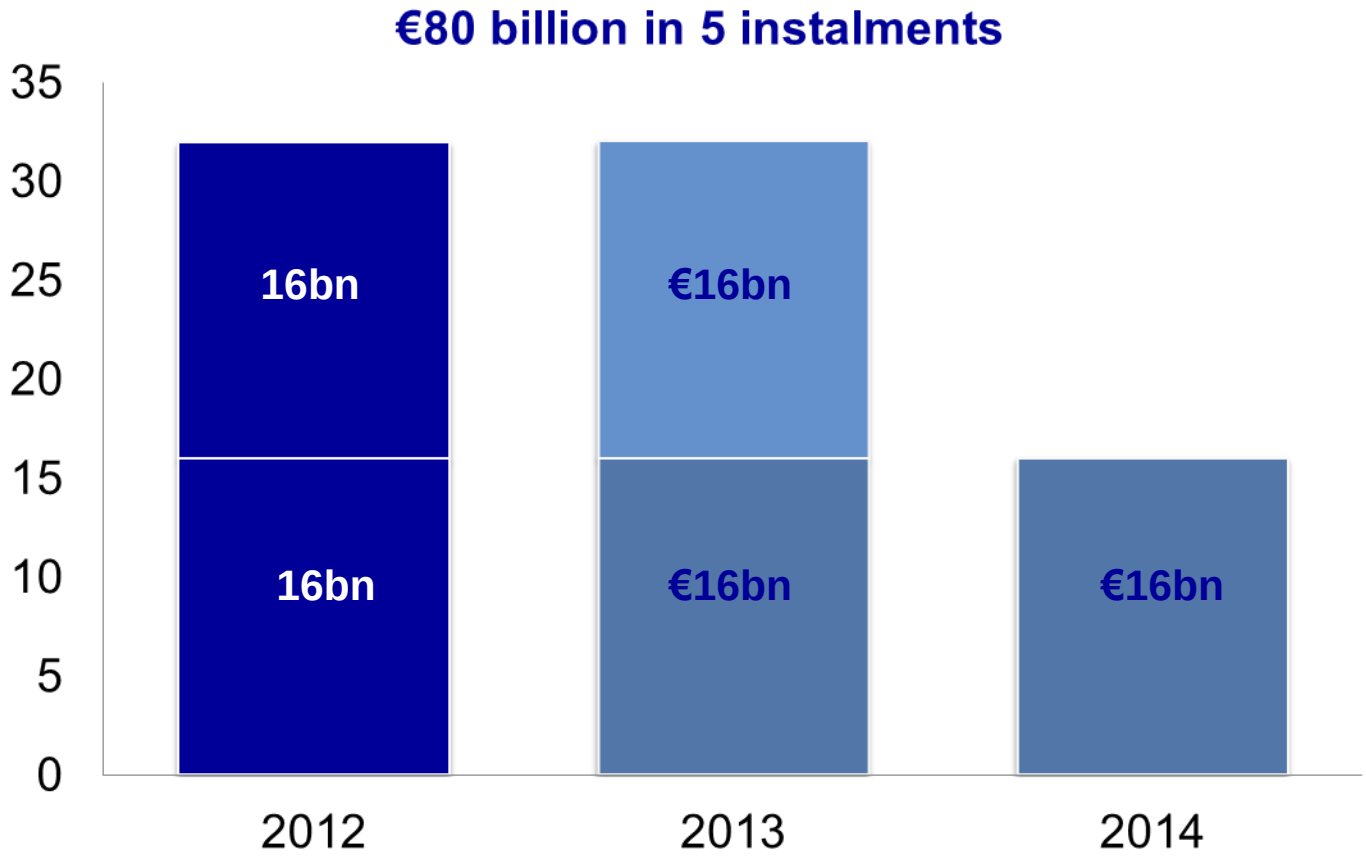
- Strong capital metrics – Paid-in Capital / Subscribed Capital = 11.4%
- Paid-in Capital not available for on-lending, mainly invested in high quality liquid assets

Highly reliable callable capital mechanism

- under emergency situation to avoid ESM payment default
  - Managing Director makes capital call to ESM shareholders without any additional approval requirements
  - ESM shareholders irrevocably and unconditionally have undertaken to pay on demand such capital within 7 days
- to replenish Paid-In Capital – simple majority of Board of Directors required
  - Restore level of Paid-in Capital due to non-payment by beneficiary Member State and/or to maintain minimum 15% threshold of Paid-In Capital/maximum lending volume
- Strictly limited payment obligations for each ESM member as stipulated in Annex II of ESM Treaty

Subscription to paid-in capital accelerated

- Initially programmed over 5 years, the paid-in capital instalments have been accelerated
- The first two instalments (€32 billion) have been paid in



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ESM Governance structure

Shareholders	17 euro area Member States
Board of Governors	Each ESM shareholder appoints one Governor (Minister of Finance) and one alternate, Observers – Commissioner for economic and monetary affairs, President ECB, President of Euro Group (if not Chairman)
Board of Directors	Each Governor appoints one Director and one alternate Observer – EC and ECB
Managing Director	Klaus Regling, appointed for 5 years, assisted by Management Board

Board of Governors

Each ESM shareholder appoints one Governor (Govt. member responsible for Finance) and one alternate, Observers – Commissioner for economic and monetary affairs, President ECB, President of Euro Group

ESM Board of Governors

Chaired by President of the Euro Group or by Chairperson elected from BoG members for 2 years.

Decisions by mutual agreement

(unanimity of members participating in the vote)

- Issue new shares, make capital calls (unless emergency situation) , change authorised capital stock and adapt maximum lending volume
- Provide stability support and to establish to choice of instruments and the financial terms and conditions, gives mandate to EC to negotiate MoU in liaison with ECB
- Change list of financial instruments of ESM, modalities of transfer of EFSF support to ESM

Decisions by qualified majority

(80% of the votes cast)

- Technical terms of accession to ESM
- Set out by-laws and rules of procedure
- Actions to be taken for recovering a debt from an ESM member
- Appoint Managing Director and members of the Board of Auditors
  Approve annual accounts and external auditors

For all decisions, a quorum of 2/3 of the members with voting rights representing at least 2/3 of the voting rights must be present

European Stability Mechanism

ESM Board of Directors

- ESM Board of Governors may delegate its task(s) to Board of Directors
- Ensures ESM is run in accordance with its Treaty and by-laws

Decisions by mutual agreement

(unanimity of members participating in the vote)

- Decides by mutual agreement (following proposal by Managing Director and after received report from EC) whether credit line should be maintained
- ESM loans and recapitalisations of financial institutions – disbursement of tranches subsequent to 1st tranche
- Primary and secondary market support facility – disbursement of financial assistance

Decisions by qualified majority

(80% of the votes cast)

- Decisions taken by qualified majority (unless otherwise stated by ESM Treaty)
- HR and budgetary issues

For all decisions, a quorum of 2/3 of the members with voting rights representing at least 2/3 of the voting rights must be present

ESM Managing Director

- Responsible for day-to-day management of ESM
- Appointed from among candidates with high level of competence in economic and financial matters
- 5 year term of office; may be re-appointed once
- Chairs meetings of Board of Directors
- Legal representative of ESM and conducts its current business

ESM investment guidelines

- Paid-in capital is key pillar for the credibility and creditworthiness of ESM
  - Proceeds from returns will be partly used to cover operating and administrative cost
- Therefore, investment policy will be prudent and conservative
  - Liquid portfolio
  - Eligible assets with high creditworthiness
  - Diversification within the fixed income universe
  - Investment universe mainly euro-denominated SSA

How the ESM works:
loan disbursement and funding strategy

ESM: procedure for granting stability support

Application for support
EAMS makes **formal request** to Chairperson of ESM Board of Governors

Assessment
European Commission, in liaison with ECB assesses the following:
- risk to EA financial stability,
- whether country's public debt is sustainable (wherever appropriate together with IMF)
- actual or potential financing needs of country

Proposal
Based on assessment, ESM MD makes proposal for adoption by ESM Board of Governors whether to grant support in the form of a financial assistance facility

Approval of support terms
A common **Memorandum of Understanding** of policy conditionality is established between the EC, the IMF (where applicable) and beneficiary country and approved by Board of Governors. ESM MD prepares a **Financial Assistance Facility Agreement** (FFA). The FFA establishes the financial terms of the support in compliance with the policy conditions. It is adopted by ESM Board of Governors.

Financial support
After ensuring compliance with policy conditions, ESM **makes support available** to borrower

3 to 4 weeks

European Stability Mechanism

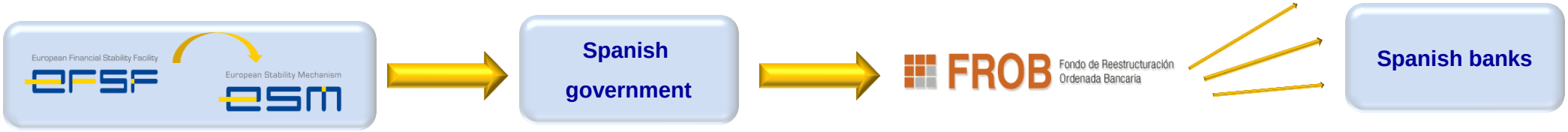
Recapitalisation of the Spanish financial sector

Objectives of the programme

- Recapitalise the Spanish banking sector and restore market confidence in Spain

Financing

- Loan covers estimated shortfall in capital requirements (€51-62 bn) with additional safety margin summing up to a total of €100 bn
- Loan maturities will be up to 15 years with an average of 12½ years
- Committed under EFSF and then transferred to ESM (without seniority status)



Conditions

- Applied to individual financial institutions
- Compliance with agreed EU surveillance recommendations
- Reforms targeting the financial sector as a whole, restructuring plans in line with EU state aid rules
- Reinforcement of regulatory and supervisory framework in Spain

ESM issuance

ESM Funding Strategy

For investors

- Provides highly liquid investment opportunities
- Offers a regular issuance programme (short-term and long-term)
- Provides coverage across the whole yield curve

For beneficiary countries

Offering funding at best conditions with priority given to

- Mitigating ESM liquidity and interest rate risk
- Proposing the best balance between costs and maturities

ESM funding

Short term funding

- Regular bill programme
- Unsecured money market

Long term funding

- Highly liquid benchmark bonds
  - 3 year – 30 year
  - Taps possible
  - Via syndications, auctions
  - Private placements
  - Non euro currencies allowed

Fund pool

- Funds are not attributed to one country but pooled
- One unique rate for all countries

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ESM Base Rate for the Diversified Funding Strategy

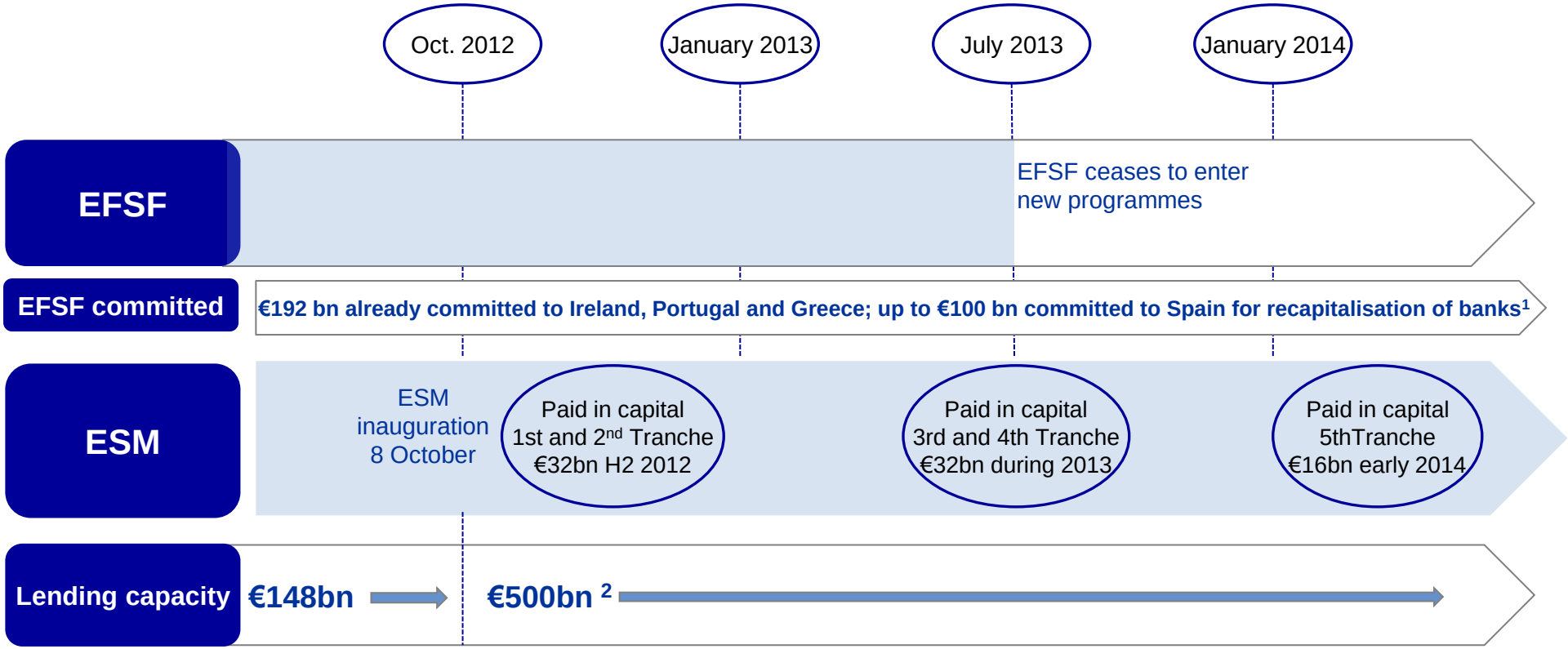
- **ESM Base Rate:** Calculated as the daily average interest rate resulting from the funding pooling (long-term pool and short-term pool of funds). This rate only changes when the pools composition changes, due to roll-overs, new funding, redemptions, etc.

- **Principle of no discrimination:** The daily base rate is equally applied to all facilities in order to ensure equal treatment among beneficiaries → All countries pay the same rate at the same day, and accrue in accordance with their specific loan maturities. The beneficiary countries pay a variable rate as the Base Rate changes over time

- **Assignment of Proceeds:** The base rate is computed using the following principle: the total size of proceeds from the Long-term Pool is assigned to the outstanding amounts under the ESM Facilities. Any shortfall would be covered by funds from the Short-term Pool.

- **Liquidity Buffer:** The remaining amount from the short-term pool not allocated to current disbursements will serve as a liquidity buffer for the ESM in order to face urgent needs or manage liquidity gaps. Limits for the size of the liquidity buffer and the short-term pool are authorised by Member States

The combined capacity of ESM and EFSF: €700 billion



[1] The amount provided to Spain for bank recapitalisation will be transferred to the ESM, thus the combined EFSF-ESM lending capacity of €700 bn will be maintained

[2] Up to July 2013 the EFSF may engage in new programmes if necessary to ensure a full fresh lending capacity of €500 billion. €500 bn lending capacity can also be reached through accelerated capital payments, if needed.

European Stability Mechanism

What will happen to EFSF?

- EFSF will complete existing programmes for Ireland, Portugal and Greece and manage the rollover of existing debt
- The financial assistance for the recapitalisation of the Spanish banking sector will be transferred to ESM
- Up to mid July 2013, EFSF may engage in new programmes if necessary to ensure a maximum full fresh lending capacity
- Following the conclusion of existing programmes, EFSF will exist in an administrative capacity until all outstanding debt has been repaid (including refinancing operations)
- Once outstanding debt and loans have been repaid, EFSF will close down
- EFSF staff has become ESM staff

EFSF funding programme

Preliminary EFSF funding programme
(subject to market conditions and requests by programme countries)

€ billion	2011 (completed)	Q1 2012 (completed)	Q2 2012 (completed)	Q3 2012 (completed)	Q4 2012	Total for 2012	2013	2014
Ireland	7.5	1.75	2.8	0.0	**0.0**	**4.55**	**5.7**	**-**
Portugal	6.9	2.75	5.2	2.6	**2.4**	**12.95**	**2.85**	**3.45**
Greece	-	5.9	8.5	0.0	**11.2**	**25.6**	**20.3**	**29**
Total Lending Requirements	14.4	10.4	16.5	2.6	**13.6**	**43.1**	**28.85**	**32.45**
Long Term Funding Programme	16.0	8.5	10.5	11.48	**11.0**	**41.48**	**40.50**	**33.2**
Outstanding Bill Programme (end of quarter)	2.0	14.4	21.8	15.2	**14.4**	**-**	**12.0**	**12.0**

Please note that figures are based on estimates and may vary depending upon market conditions
Negative gaps between Lending requirements and Long Term Funding will be covered by the Bill Programme.

European Stability Mechanism

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Primary Market Support Facility (PMSF)

Objective: to allow Member States to maintain or restore their market access

Circumstances

- Countries under a macro-economic adjustment programme or to drawdown of funds under a precautionary programme.
- Primarily used towards the end of an adjustment programme to facilitate a country's return to the markets

Conditions: Those of macro-economic adjustment programme or the precautionary programme as stated in relevant MoU

Limit: No more than 50% of the final issued amount

Once purchased: ESM could

- Resell to private investors once market conditions have improved
- Hold until maturity
- Sell back to country
- Use for repos with commercial banks to support ESM's liquidity management

Secondary Market Support Facility (SMSF)

Objective: support the functioning of the debt markets and appropriate price formation in government bonds

- market making to ensure some liquidity in debt markets
- give incentives to investors to further participate in the financing of countries

Conditions:

- Programme countries: conditionality of the programme applies as in MoU
- Non-programme countries: conditionality refers to
  - ex-ante eligibility criteria as defined in the context of the European fiscal and macro-economic surveillance framework
  - appropriate policy reforms as in MoU

Procedure:

- Initiated by a request from a ESM Member to Chairperson of ESM's Board of Governors
- In all cases, subject to an ECB report identifying risk to euro area and assessing need for intervention.

Precautionary financial assistance

Objective: prevent crisis situations by assistance before Member States face difficulties raising funds in the capital markets and avoid negative connotation of being a programme country

- **Precautionary conditioned credit line (PCCL)**
  - access limited to countries with sound economic and financial situation,
  - Clear track record of access to capital markets, respect of SGP* and EIP* commitments
- **Enhanced conditions credit line (ECCL)**
  - access open to countries with moderate vulnerabilities that preclude access to PCCL

Both types of credit lines can be drawn via a **loan** or **primary market purchase**

Conditions:

- Beneficiary placed under enhanced surveillance by European Commission during its availability period
- All conditions stated in MoU

Procedure:

- Request from a ESM Member to Chairperson of ESM's Board of Governors
- Commission and ECB assess country's financing needs and whether it meets required conditions

*SGP: Stability and Growth Pact, EIP: Excessive Imbalances Procedure

Financial assistance for recapitalisation of financial institutions

Objective: limit contagion of financial stress by assisting a country to finance recapitalisation of financial institution(s) at sustainable borrowing costs (particularly to countries where a crisis situation has its source in the financial sector).

Circumstances: Countries that are not under a macro-economic adjustment programme*. Any loans must be requested and disbursed to Member States. ESM will not loan directly to financial institutions until a single supervisory mechanism (SSM) is in place for euro area banks.

Eligibility criteria:

1. Lack of alternatives for recapitalising financial institution(s) via private sector solutions
2. Inability of ESM Member to recapitalise financial institution(s) without incurring adverse effects on its financial stability and fiscal sustainability
3. Ability to reimburse the loan, even when ESM Member would not be able to recover capital injected in beneficiary institution(s)

Conditions:

- Restructuring/resolution of financial institutions
- Compliance with European state aid rules
- Additional conditionality on financial supervision, corporate governance and domestic laws on restructuring/resolution.
- All conditions stated in MoU

* Those countries under a programme, an amount has already been designated within the programme for the recapitalisation of the financial sector (ie €12 billion for Portugal, €35 billion for Ireland)