

## Frequently Asked Questions on the European Stability Mechanism (ESM)

### Section A – General questions about the ESM

#### ➤ A1 – What is the European Stability Mechanism (ESM)?

The ESM is a permanent crisis resolution mechanism for the countries of the euro area. Its purpose is to provide stability support through a number of financial assistance instruments to ESM Member States which are experiencing, or are threatened by severe financing problems. For this purpose, the ESM is entitled to raise funds by issuing financial instruments or by entering into financial or other agreements with ESM Members, financial institutions or other third parties.

The ESM may provide stability support by:

- providing loans to countries in financial difficulties,
- purchasing bonds of an ESM Member State in primary and secondary debt markets,
- providing precautionary financial assistance in the form of a credit line,
- financing recapitalisations of financial institutions through loans to governments including in non-programme countries.

All financial assistance to Member States is linked to appropriate conditionality.

The ESM will use an appropriate funding strategy so as to ensure access to broad funding sources and enable it to extend financial assistance packages to Member States under all market conditions.

#### ➤ A2 – What is the legal basis of the ESM and how was it established?

On 17 December 2010, the European Council agreed that the Treaty on the Functioning of the European Union (TFEU) should be amended in order for a permanent mechanism - the European Stability Mechanism - to be established by the Member States whose currency is the euro to safeguard the financial stability of the euro area as a whole. The amendment (in Article 136 of the Treaty) was adopted by the European Council on 25 March 2011.<sup>1</sup>

The Treaty Establishing the ESM was originally signed by finance ministers of the 17 euro area countries on 11 July 2011. However, a modified version of the Treaty, incorporating amendments aimed at improving the effectiveness of the mechanism, was signed in Brussels on 2 February 2012.

The ESM Treaty entered into force on 27 September 2012 and the European Stability Mechanism was inaugurated on 8 October 2012 following ratification by all 17 euro area Member States.

#### ➤ A3 - What is the legal form of the ESM?

The ESM is established as an intergovernmental organisation under public international law.

#### ➤ A4 – Where is the ESM headquartered?

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<sup>1</sup> [http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/ec/120296.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/120296.pdf)

The ESM's office is in Luxembourg.

➤ **A5 – Who governs the ESM? How are decisions taken?**

The ESM has a Board of Governors consisting of the Ministers of Finance of the euro area Member States (as voting members), while the European Commissioner for Economic and Monetary Affairs and the ECB President may participate as observers.

The most important decisions taken by the Board of Governors require mutual consent (unanimity). These include decisions to provide stability support to an ESM Member, the choice of instruments, conditions and terms of such support, calling in authorised unpaid capital (with the exception of emergency capital calls), changing the authorised capital stock and adapting the maximum lending volume.

In a number of areas the Board of Governors take decisions by qualified majority (defined in the ESM Treaty as 80% of the votes cast, with voting rights equal to the number of shares allocated to each country). These areas include setting out the detailed terms of accession of a new member to the ESM, appointing the Managing Director, and approving the annual accounts of the ESM.<sup>2</sup>

The ESM also has a Board of Directors. Each euro area country appoints one Director and one alternate Director from among people of high competence in economic and financial matters. As in the case of the Board of Governors, the European Commission and ECB may appoint a non-voting observer. The Board of Governors may delegate to the Board of Directors one or more tasks entrusted to the former by the ESM Treaty. As a rule, decisions of the Board of Directors are taken by qualified majority, however, it may not take any action pursuant to such delegation which is inconsistent with any action taken by the Board of Governors.

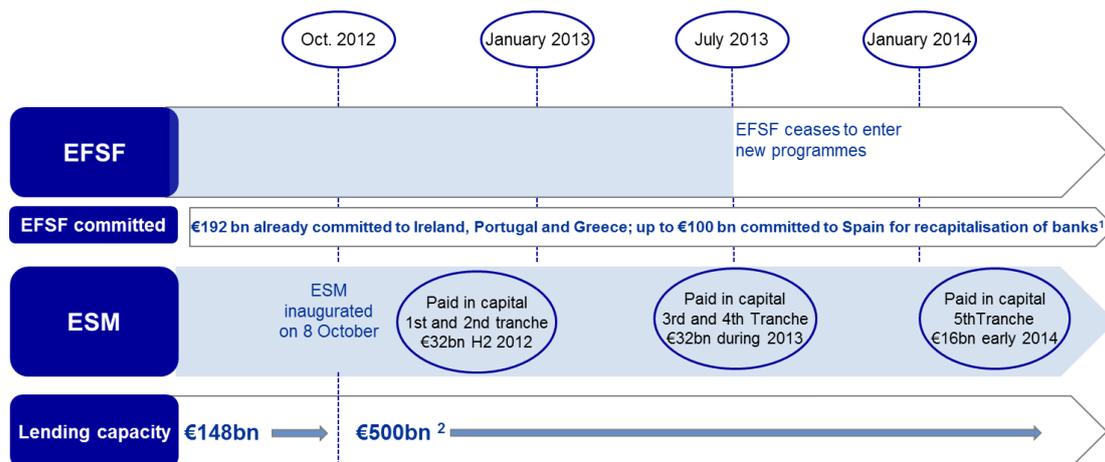
The Board of Governors appoints a Managing Director responsible for the day-to-day management of the ESM. The Managing Director chairs the Board of Directors, as well as the Management Board, which assists the Managing Director in conducting the current business of the ESM. The term of office of the Managing Director is 5 years. He/she may be reappointed once. While holding office, the Managing Director may not be a Governor, Director or an alternate of either.

➤ **A6 - What is the ESM's lending capacity?**

The ESM's maximum lending capacity is €500 billion. During the Eurogroup meeting held on 30 March 2012, it was decided that the EFSF would continue to fund the existing Facility Agreements for Portugal, Ireland and Greece. The combined lending capacity of EFSF/ESM, as illustrated by the diagram below, is therefore €700 billion.

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<sup>2</sup> A full list of issues decided by mutual consent and QMV by the Board of Governors can be found in Article 5 of the ESM Treaty.



<sup>1</sup> The amount provided to Spain for bank recapitalisation will be transferred to the ESM once it becomes operational, thus the combined EFSF-ESM lending capacity of €700 bn will be maintained

<sup>2</sup> Up to July 2013 EFSF may engage in new programmes in order to ensure a full fresh lending capacity of €500 billion. €500 bn lending capacity can also be reached through accelerated capital payments, if needed.

➤ **A7 – What is the status of the European Financial Stability Facility (EFSF)?**

The ESM will be the main instrument to finance new programmes. The EFSF is envisaged to only remain active in financing programmes that started before the ESM Treaty was signed. However, for a transitional period until 2013, the EFSF may engage in new programmes in order to ensure a full fresh lending capacity of €500 billion. After 2013, EFSF will continue functioning until all outstanding loans and bonds have been repaid.

➤ **A8 – How is the ESM's capital structured?**

The ESM has a total subscribed capital of € 700 billion. Of this amount, €80 billion will be in the form of paid-in capital provided by the euro area Member States in five instalments of €16 billion. Two instalments of capital will be paid within 15 days after the ESM Treaty comes into force, another two instalments will be paid in 2013 and a final in the first half of 2014.

In addition, the ESM will also dispose of committed callable capital from euro area Member States to a total amount of €620 billion. During the transitory phase from 2013 to 2014, Member States commit to accelerate, in the unlikely event that this is needed, the provision of appropriate instruments in order to maintain a minimum 15 per cent ratio between paid-in capital and the outstanding amount of ESM issuances.

➤ **A9 – When can capital calls be made?**

There are three different instances when a capital call can be made:

- 1) General capital calls
- 2) Capital calls to replenish paid-in capital
- 3) Emergency capital calls

1) A general capital call concerns payment of the initial capital and an increase of paid-in capital which could be necessary, for example, to raise the lending capacity. To initiate such a call, the Managing Director of the ESM, would make a proposal to the Board of Governors outlining the objective of such a call, the amounts and contributions for each shareholder and a proposed payment schedule. The Board of Governors, with mutual agreement, may call in authorized capital at any time.

2) A capital call to replenish paid-in capital could happen for two reasons: a) to cover any losses in paid-in capital due to a non-payment by a beneficiary country and b) in order to

maintain a minimum 15% ratio between paid-in capital and the lending capacity of ESM. The Managing Director would again make a proposal, this time to the Board of Directors, which would specify the losses incurred and the underlying reasons. Simple majority of the Board of Directors is required to agree to call in capital under these circumstances. If any ESM member fails to meet the required capital call, one or more revised increased capital calls would be made to all ESM Members by increasing the contribution rate of the remaining ESM Members on a pro-rata basis. When the ESM Member which failed to contribute settles its debt to the ESM, the excess capital is returned to the other ESM Members.

- 3) Finally, an emergency capital call would be used for the acceleration of the paid-in capital during the ramp-up period to comply with the requested capital ratio and to avoid default of an ESM payment obligation to its creditors. The Managing Director would have the responsibility to make such a capital call to ESM shareholders if there were such a risk of default. As stated in the ESM treaty, the ESM shareholders have irrevocably and unconditionally undertaken to pay on demand such a capital within 7 days of receipt of the demand. However, if any ESM Member fails to meet the required capital call, the same procedure would apply as for capital calls to replenish paid-in capital. This mechanism works effectively like a guarantee and provides the strongest possible assurance to ESM bondholders that they will always be serviced and repaid.

- [A10 – Does the ruling of the German Constitutional Court of 12 September 2012 have an effect on the way the capital calls work?](#)

No, the ruling of the German Constitutional Court does not change anything for Germany with respect to capital calls. All Member States share this interpretation of the Court's ruling. The particular payment obligations of each future ESM member resulting from the capital calls mentioned above are limited to the amounts stipulated in Annex II to the ESM Treaty. In the case of Germany, for instance, any liability is capped at €190 billion, unless ESM Members unanimously agree to change the amount of subscribed capital.

- [A11 – Will the ESM be able to use the paid-in capital to purchase sovereign bonds in the market?](#)

The paid-in capital will be invested in high quality liquid assets and in accordance with ESM investment guidelines. It will serve as loss absorbing capital only. Thus the paid-in capital will not be used to purchase sovereign bonds under an ESM primary or secondary market intervention, but it could be used to purchase top-rated and liquid sovereign bonds for investment purposes.

- [A12 - What is the ESM's shareholder contribution key?](#)

The ESM shareholder contribution key is based on the ECB contribution key.<sup>3</sup> Member States with a GDP per capita of less than 75% of the EU average will benefit from a temporary correction for a period of 12 years after their entry in the euro area. The temporary correction will be three quarters of the difference between GNI and ECB capital shares. The downwards compensation on those countries is redistributed among all the other countries according to their ECB key shares:

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<sup>3</sup> The ECB contribution key is calculated to reflect the respective country's share in the total population and gross domestic product of the EU. These two determinants have equal weighting.

Country	ESM Key (%)	Capital subscription (€ bn)
Austria	2.783	19.48
Belgium	3.477	24.34
Cyprus	0.196	1.37
Estonia	0.186	1.30
Finland	1.797	12.58
France	20.386	142.70
Germany	27.146	190.02
Greece	2.817	19.71
Ireland	1.592	11.14
Italy	17.914	125.39
Luxembourg	0.250	1.75
Malta	0.073	0.51
Netherlands	5.717	40.02
Portugal	2.509	17.56
Slovakia	0.824	5.77
Slovenia	0.428	2.99
Spain	11.904	83.32
<b>Total</b>	<b>100</b>	<b>700.00</b>

➤ A13 – What is the reserve fund?

The net income generated by the ESM operations, as well as the proceeds of the financial sanctions received from the ESM Members under the multilateral surveillance procedure, the excessive deficit procedure and the macro-economic imbalances procedure established under the TFEU will be put aside in a reserve fund. The resources of the reserve fund will be invested in accordance with guidelines adopted by the ESM's Board of Directors.

➤ A14 – Does the ESM provide specific credit enhancements?

The ESM will aim to obtain and maintain the highest credit rating from the major credit rating agencies.

The ESM will have a capital structure similar to multilateral lending institutions. It can be expected that this will be reflected in the assessment by credit rating agencies in line with their general standards for subscribed capital and operating procedures of such institutions.

Unlike the EFSF, ESM's structure will comprise paid-in capital and callable capital and therefore credit enhancements will not be required.

➤ A15 – How would losses arising from ESM operations be charged?

If such losses occur, they will be charged firstly against the reserve fund, secondly against the paid-in capital and lastly against an appropriate amount of authorised unpaid capital.

➤ A16 – Will the IMF be involved in the ESM?

The ESM will cooperate very closely with the IMF in providing stability support. Wherever possible, a participation of the IMF will be sought on a technical and financial level. A euro area Member State requesting financial assistance from the ESM is expected to address, wherever possible, a similar request to the IMF.

➤ A17 – Will ESM loans have preferred creditor status?

It is the mutual understanding of ESM members that ESM loans under a macroeconomic adjustment programme and recapitalisation facilities will enjoy preferred creditor status in a similar fashion to those of the IMF, while accepting preferred creditor status of the IMF over the ESM. The decision to forego preferred creditor status in the case of the recapitalisation of Spanish banks was one-off in nature, as the Financial Assistance Facility Agreement (FFA) was negotiated by the EFSF. This FFA will be transferred to the ESM with rights and obligations, including the EFSF's pari passu status.

➤ A18 – Would it be possible to make changes to the seniority status and empower the ESM to directly recapitalise banks without amending the ESM treaty?

Seniority for ESM loans is a mutual understanding between ESM members and is mentioned in recital (13) of the ESM treaty. Reference is made to the decision of Heads of State and Government in that regard. A repeal or amendment of their earlier statement would therefore also require a decision by the Heads of State or Government. In several Member States it would require support by the national parliament.

With regards to direct bank recapitalisation, based on Article 19 of the ESM Treaty it would be possible without a treaty change, by a unanimous decision of the Board of Governors.

➤ A19 – Can non-euro area Member States participate in ESM programmes?

Non-euro area Member States may participate on an ad hoc basis alongside the ESM in financial assistance operations for euro area Member States.

➤ A20 – What is the procedure granting stability support from the ESM?

Financial assistance from the ESM will in all cases be activated upon a request from a Member State to the Chairperson of the ESM's Board of Governors.

If ESM Stability Support is requested, the Commission in liaison with the ECB will assess the existence of a risk to the financial stability of the euro area as a whole. It will also assess whether public debt is sustainable. Wherever appropriate and possible, such an assessment is expected to be conducted together with the IMF. It will also assess the actual financing needs of the Member State concerned.

Based on this assessment, the Commission will negotiate in liaison with the ECB, and wherever possible, together with the IMF, a Memorandum of Understanding (MoU) detailing the conditionality attached to the financial assistance facility. The Commission will sign the MoU on behalf of the ESM.

The Managing Director of the ESM will make a proposal for financial assistance, the instrument and its terms and conditions to the Board of Governors. When the Board of Governors has adopted the overall financial support and its main terms, the Board of Directors will then approve the financial assistance facility agreement detailing the technical aspects of the assistance.

The Commission, in liaison with the ECB and, wherever possible, together with the IMF, will be responsible for monitoring compliance with the conditionality attached to the financial assistance facility.

➤ A21 – How does the ESM's emergency voting procedure work?

The ESM Treaty includes an emergency voting procedure, whereby financial assistance can be granted if supported by a qualified majority of 85% of the votes cast. When this procedure is used, a provision from the reserve fund and/or the paid-in capital to an emergency reserve

fund is made in order to cover the risks arising from the financial support granted under this procedure.

➤ **A22 – Is there a link with the “fiscal compact”?**

Following agreement reached at the European Council on 30 January 2012 on the fiscal compact, the ESM treaty now stipulates that the granting of financial assistance will be conditional, as of 1 March 2013, on the ratification of the fiscal compact by the ESM member state concerned.

➤ **A23 - Will ESM liabilities increase the government debt of the shareholder countries?**

No. According to a preliminary note published by Eurostat,<sup>4</sup> the ESM will be treated in the same way as similar international financial organisations such as the IMF. Loans from the ESM to a euro area country in need will be recorded in the same way as a loan from the IMF to a Member State (i.e. as a direct loan from an international organisation to the country in question). Therefore, unlike the loans provided by the EFSF, the loans provided by the ESM will not be rerouted through the accounts of other euro area countries and will therefore not increase their government debt.

➤ **A24 – Are the ESM's accounts subject to external audit?**

Yes, the accounts of the ESM will be audited by independent external auditors, who will have the power to examine all books and accounts and obtain full information about the ESM's transactions.

In addition the ESM will have a Board of Auditors consisting of five members appointed by the Board of Governors. It will include two members from the supreme audit institutions of the ESM Members - with a rotation between the latter - and one from the European Court of Auditors.

➤ **A25 – Is there a procedure for settling disputes?**

Yes, the Board of Governors will decide on any dispute arising between an ESM Member and the ESM, or between ESM Members, in connection with the interpretation and application of the ESM Treaty. If an ESM Member contests such a decision taken by the Board of Governors, the dispute will be submitted to the Court of Justice of the European Union.

➤ **A26 – Do you intend to ask for a banking license for the ESM?**

No. The ECB published an analysis last year according to which the ECB is not allowed for legal reasons to grant the ESM a banking license, which holds similar for the EFSF. It should be pointed out that the question of a banking license is often over-interpreted. It would make funding easier, but would not allow unlimited lending by the EFSF or ESM.

## **Section B – ESM and EFSF working together**

➤ **B1 – Will the ESM and EFSF be parallel in the market?**

Yes, it is likely. EFSF and ESM issuance will be managed by the same team, ensuring full coordination between the two entities but working on the basis of two separate balance sheets.

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<sup>4</sup><http://www.cmfb.org/pdf/2011-04-07%20Eurostat%20preliminary%20view%20on%20the%20recording%20of%20the%20European%20Stability%20Mechanism.pdf>

➤ B2 – Do the ESM and EFSF share the same staff?

Yes, existing EFSF staff have started performing their respective tasks for the ESM. The current number of employees is approximately 60.

➤ B3 – Will the ESM and EFSF be merged?

The EFSF is a company established under Luxembourg law whereas the ESM is an intergovernmental institution established under international law. As legal entities with such different structures, the two institutions will not be merged.

However, the current staff of the EFSF will also work for the ESM. This will ensure that the ESM will be fully operational in October. It will also allow the ESM to benefit from the experience gained by the EFSF staff. Over the last two years, EFSF has become a well-established issuer in the sovereign debt market. We fully expect to continue this success with the ESM.

➤ B4 – Will the EFSF continue to issue bonds under the existing programmes for Ireland, Portugal and Greece? Will the EFSF adjust its funding target once the ESM is operational?

The EFSF will finance the programmes that started before the ESM Treaty was signed. It will therefore continue to issue bonds to fund the programmes for Ireland, Portugal and Greece. As the funding activity remains the same, no adjustments to its funding targets are necessary.

➤ B5 – Assuming that one of these countries needs further support than the scheduled €192bn, does this mean that the EFSF could also issue more bonds after 2014 (when the program for Greece is supposed to end)? Or will the ESM take care of that additional financing? However, this would still leave the combined EFSF/ESM lending volume cap at EUR700bn?

If one of these countries were to need further support, a new programme and a new Memorandum of Understanding would be necessary. Granting such a programme would require a decision at political level. It would in principle not be undertaken by the EFSF, which will not be able to initiate new programmes after 30 June 2013.

➤ B6 – Can EFSF support commitments be transferred to the ESM?

Yes, the Board of Governors of the ESM may decide that the EFSF commitments to provide financial assistance will be assumed by the ESM, in particular as far as such commitments relate to undisbursed and unfunded parts of loan facilities.

➤ B7 – There is a theoretical possibility that the ESM would take over EFSF bonds in the ESM Treaty. Will this happen? What would be the process?

No, this is not currently envisaged.

## Section C – Funding

➤ C1 – When will the ESM start to issue and what will its yearly funding volume be?

Any ESM issuance will depend upon if and when an ESM Member State submits a request for financial assistance. Similarly, the funding volume cannot be known until a request for

assistance has been made and a programme has been determined. An ESM bill programme is currently under discussion by Member States.

➤ C2 – Will the ESM do its own funding?

The ESM is empowered to borrow on capital markets from banks, financial institutions or other persons or institutions for the performance of its purpose. Issues may be made via syndications, auctions, private placements and new lines.

Since the EFSF was established, the German Debt Management Office (Bundesrepublik Deutschland – Finanzagentur GmbH) has acted as Issuance Agent and has been responsible for the placement. For the ESM, the German DMO will initially continue to perform the same role. The ESM is the issuer of all debt instruments, which fall into the category of SSA (Sovereign, Supranational, Agency) issuance.

➤ C3 – What are the ESM's funding objectives and principles?

In order to effectively perform its purpose of providing stability support to euro area countries, the ESM pursues the following objectives with respect to funding: (i) the ESM must be able to react quickly to unexpected market developments and to that end it will build up liquidity buffers during periods of heightened systemic risk to ensure market access even in a difficult market conditions; (ii) the ESM must be capable of raising predictable amounts over an extended period of time covering various disbursement schedules, as well as unexpected amounts on relatively short notice; (iii) to achieve the aim of establishing itself as a reliable issuer in a difficult market environment, the ESM's funding portfolio will comprise liquid instruments with a simple, plain vanilla structure.

➤ C4 – What is the ESM's funding strategy?

The ESM applies a diversified funding strategy, which entails the use of a variety of instruments and maturities to ensure the efficiency of funding and continuous market access. One feature of this strategy is that funds raised through various instruments are not attributed to a particular country. The funds are pooled and then disbursed to programme countries. The ESM applies two such pools: a short-term and medium-to-long-term funding pool.

➤ C5 – What funding tools does the ESM apply?

The ESM applies capital market and money market instruments. Capital market tools include benchmark bonds issued with maturities ranging from 1 to 30 years. The ESM may hold its own bonds for a limited amount, so that additional funding may be raised by selling the bonds on the secondary market or by using them as collateral in the secured money market. As a supplement to the bond programme, the ESM may issue promissory/registered notes.

The ESM issues bills through regular auctions and may also engage in unsecured money market transactions. Transactions may be conducted overnight, on a rolling basis or for tenors up to one year. The ESM may also issue commercial paper, money market promissory notes and engage in repo transactions. In addition, the ESM has established liquidity lines with the DMOs of ESM members and a network of credit lines with private banks.

➤ C6 – Do you expect ESM bonds to be trading tighter than EFSF?

Thanks to the stronger and more transparent capital structure (paid-in capital) of the ESM, it may be envisaged that the ESM would obtain more favourable funding costs. However, these costs also depend on market conditions, thus it may be premature to speculate on this issue.

➤ C7 – Will the ESM be able to participate in the repo market to finance bond purchases?

No, with regard to the ECB's repo operations. Yes, with private banks or other market participants.

- C8 – Can we expect the ESM to provide partial risk protection certificates or co-investment funds in the near future? Or is it only a theoretical option, which will not be used?

ESM Member States are considering extending to the ESM the options introduced last year to maximise the capacity of the EFSF: the partial protection certificates and the co-investment funds. These options could be used to support market access for countries within a full or precautionary programme.

Technical work is under way and will be considered in due course by the ESM governing bodies once the ESM is operational.

- C9 – Which banks may be appointed as lead managers?

The lead managers will be mandated from the 43 international institutions that make up the ESM Market Group (these are the same institutions that comprise the EFSF Market Group<sup>5</sup>). The lead managers are chosen following a rigorous and transparent selection process.

- C10 – Who will be the main investors in ESM bonds?

As with the EFSF, it is expected that investors in ESM bonds will predominantly be institutional investors such as banks, pension funds, central banks, sovereign wealth funds, asset managers, insurance companies and private banks.

- C11 – Does the ESM issue in euros only?

The ESM will initially focus on establishing a curve of benchmarks denominated in euros. The ESM may then further diversify its funding strategy by issuing in currencies other than the euro. Such foreign currency issues would be hedged through swap contracts.

## **Section D – Stability support loans within a macro-economic adjustment programme**

- D1 - What is the objective of ESM stability support loans?

The objective is to assist ESM Members that have significant financing needs but have to a large extent lost access to market financing, whether because they cannot find lenders or because lenders will provide financing only at excessive prices that would adversely impact the sustainability of public finances.

- D2 - What is the procedure for granting a stability support loan?

An ESM Member may address a request for stability support to the Chairperson of the ESM Board of Governors. In such case, the European Commission in liaison with the ECB and wherever possible, together with the IMF, will assess the financing needs of the ESM Member concerned and whether its public debt is sustainable. Based on this assessment, the Managing Director will prepare a proposal for adoption by the Board of Governors whether to grant a stability support loan to the ESM Member. If such a decision is taken, the European Commission in liaison with the ECB, and wherever possible, together with the IMF, will negotiate with the ESM Member concerned a Memorandum of Understanding (MoU) detailing

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<sup>5</sup> For a full list of institutions, please see [http://www.efsf.europa.eu/attachments/fi/efsf\\_market\\_group\\_en.pdf](http://www.efsf.europa.eu/attachments/fi/efsf_market_group_en.pdf)  
8 October 2012

the conditionality of the financial assistance facility. In parallel, the Managing Director of the ESM will prepare a financial assistance facility agreement (FFA).

The European Commission will sign the MoU on behalf of the ESM, subject to approval by the Board of Governors. The Board of Directors will then approve the FFA and, where applicable, the disbursement of the first tranche of assistance.

➤ D3 – How will the loans be disbursed?

Loans will be provided in one or more tranches, which may each consist of one or more disbursements. The disbursement of the first tranche will be decided by the Board of Directors together with the approval of the financial assistance facility agreement.

A decision regarding the disbursement of subsequent tranches of financial assistance will be taken by the Board of Directors on a proposal from the Managing Director, and after having received a report from the European Commission on the monitoring of and compliance by the beneficiary ESM Member with the policy conditionality attached to the FFA.

➤ D4 - How fast can the ESM provide financial support?

Following a request from a euro area Member State for financial assistance, as a rule it takes three to four weeks to draw up a support programme including sending experts from the Commission, the IMF and the ECB to the country in difficulty. Once euro area finance ministers have approved the country programme, the ESM would need several working days to raise the necessary funds and disburse the loan.

➤ D5 – What kind of conditions may be linked to ESM support?

Any financial assistance to a country in need is linked to policy conditions which are set out in the (MoU) between the country in need and the European Commission. For example, conditions for the EFSF Irish programme included strengthening and overhaul of the banking sector, fiscal adjustment including correction of excessive deficit by 2015 and growth enhancing reforms, in particular of the labour market.

➤ D6 – Who will monitor compliance with the policy conditionality associated with the financial support?

The European Commission, in liaison with the ECB, and wherever possible, the IMF, will be entrusted with the monitoring. The beneficiary ESM Member will be obliged to provide to these institutions all the information that is deemed necessary for the monitoring of the policy conditionality of the programme as agreed in the MoU. The beneficiary state will also provide the ESM all information necessary to conduct its financial due diligence.

➤ D7 - What happens if a beneficiary country fails to meet the conditions?

If monitoring processes highlight significant deviations from the macroeconomic adjustment programme, the Board of Governors may consider that the beneficiary ESM Member does not comply with the policy requirements specified in the programme. In such case, disbursements of a tranche will stop until the Board of Governors decides to re-authorise them.

➤ D8 - What is the maturity of ESM loans?

The ESM Treaty does not specify any maturity limitations for the loans. They will be defined on a case-by-case basis.

➤ D9 - What is the interest rate of ESM loans?

When granting stability support, the ESM will aim to fully cover its financing and operating costs and will include an appropriate margin.

➤ D10 - Does the ESM support countries outside the euro area?

No. For Member States outside the euro area, other European Union support mechanisms exist, such as the Balance of Payments facility;<sup>6</sup> while for countries outside the EU there is the Macro-Financial Assistance programme.<sup>7</sup>

## Section E – ESM support instruments

### Bank recapitalisations

➤ E1 – What is the objective of ESM's participation of recapitalisation of financial institutions?

The aim of a loan for recapitalising financial institutions is to preserve financial stability of the euro area as a whole and of its Member States by addressing those specific cases in which the roots of a crisis situation are primarily located in the financial sector and not directly related to fiscal or structural policies. Such assistance will thus be provided in order to limit the contagion of financial stress by ensuring the capacity of a beneficiary ESM Member's government to finance recapitalisation at sustainable borrowing costs and facilitate financial sector repair so that vulnerabilities are eliminated.

➤ E2 – What are the eligibility criteria for obtaining this type of support?

The beneficiary should demonstrate the existence of a lack of alternatives for recapitalising the financial institution(s) concerned: this should first reveal an inability to meet capital shortfalls via private sector solutions (e.g. tapping new market investors or existing shareholders<sup>8</sup>) and, second, an inability of the beneficiary ESM Member to recapitalise the institution(s) without incurring very adverse effects on its own financial stability and fiscal sustainability.

In addition, the financial institution(s) concerned should be of systemic relevance or pose a serious threat to the financial stability of the euro area as a whole or of its Member States.<sup>9</sup> Their systemic dimension will be assessed taking into account, primarily, their size, interconnectedness, complexity, and substitutability.

Finally, the beneficiary ESM Member should also demonstrate its ability to reimburse the loan granted, even in cases in which it would not be able to recover the capital injected in the beneficiary institution(s) according to the timing agreed in relevant state-aid decisions. The beneficiary shall also demonstrate the existence of a sound fiscal and macroeconomic policy record.

➤ E3 - Will the ESM make loans directly to financial institutions?

Currently, the ESM may only lend to euro area Member States. However, at the euro area summit on 29 June 2012, it was proposed that once an effective supervisory mechanism is established for banks in the euro area, involving the ECB, following a regular decision the ESM could have the possibility to recapitalise banks directly.

➤ E4 – What is the request procedure?

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<sup>6</sup> See [http://ec.europa.eu/economy\\_finance/eu\\_borrower/balance\\_of\\_payments/index\\_en.htm](http://ec.europa.eu/economy_finance/eu_borrower/balance_of_payments/index_en.htm)

<sup>7</sup> See [http://ec.europa.eu/economy\\_finance/eu\\_borrower/macro-financial\\_assistance/index\\_en.htm](http://ec.europa.eu/economy_finance/eu_borrower/macro-financial_assistance/index_en.htm)

<sup>8</sup> Where a legal framework permits, such private sector solutions could also include the writing-down or conversion of debt in order to facilitate recapitalisation and a return to viability.

<sup>9</sup> According to the guideline on the recapitalisation of financial institutions, systemic relevance can refer to: (i) systemically important financial institutions that fall into the main criteria enclosed in the guideline; or (ii) other financial institutions, not necessarily cross-border, whose insolvency could have a significant negative impact on the financial system because of adverse market circumstances or financial stress.

The request should be addressed to the Chairperson of the ESM Board of Governors, indicating the institutions in distress for which financial assistance is requested, the amount of capital needed, the type of securities to be used in the recapitalisation, and the results of a recent stress-test of the institutions concerned.

The Board of Governors will then entrust the European Commission, in liaison with the ECB and where possible the relevant ESA, to assess conformity with the eligibility criteria. Based on this assessment, the Board of Governors, acting on a proposal from the Managing Director, will decide whether to grant the loan. In addition, the beneficiary ESM Member will give notice of the proposed recapitalisation to the European Commission, which will examine its compatibility with EU state aid rules.

➤ **E5 – Will conditions be attached?**

Yes, but unlike stability support within a macro-economic adjustment programme, the conditionality focuses only on the financial sector of the country in question. Conditionality will apply in the domains of financial supervision, corporate governance and domestic laws relating to restructuring/resolution. The policy conditions will be specified in an MoU negotiated by the European Commission in liaison with the ECB and relevant European Supervisory Authority.

➤ **E6 – How will the loan be disbursed?**

Recapitalisation loans will be provided in one or more tranches, which may each consist of one or more disbursements. Disbursements of tranches, subsequent to the first tranche, will be made upon a decision, by mutual agreement, of the Board of Directors, following a proposal from the Managing Director and after having received the report conducted by the European Commission, in liaison with the ECB.

➤ **E7 – Who will monitor compliance with institution-specific conditionality?**

Compliance with institution-specific conditionality related to EU state aid rules will be conducted by the European Commission, which will also be responsible for the monitoring of other policy conditions in liaison with the ECB and the relevant European Supervisory Authority (ESA). The ESAs will have the right to conduct on-site inspections in any beneficiary financial institution(s) in order to adequately monitor compliance with the conditions, and share information relevant to the reporting on compliance with the European Commission and the ECB. Where deemed necessary, the monitoring institutions shall also be authorized to involve other relevant experts, such as external auditors or monitoring trustees.

An additional assessment by the IMF of the implementation of international standards and supervisory practices should be actively sought by the beneficiary ESM Member during the period of implementation of the financial assistance.

### **Precautionary financial assistance**

➤ **E8 – What is the objective of the ESM's precautionary financial assistance?**

The objective of ESM precautionary financial assistance in the form of credit lines is to support sound policies and prevent crisis situations by allowing ESM Members to secure ESM assistance before they face major difficulties raising funds in the capital markets. Precautionary financial assistance aims at helping ESM Members whose economic conditions are still sound to maintain continuous access to market financing by reinforcing the credibility of their macroeconomic performance while ensuring an adequate safety-net.

➤ **E9 – What type of credit lines are available?**

Two types of ESM credit lines are available: a Precautionary Conditioned Credit Line (PCCL) and an Enhanced Conditions Credit Line (ECCL). A PCCL and an ECCL credit line can be drawn via a loan or a primary market purchase. Both types of credit line have an initial availability period of one year and are renewable twice, each time for six months.

- Precautionary conditioned credit line (PCCL) – available to a euro area Member State whose economic and financial situation is fundamentally sound, as determined by respecting eligibility criteria (sustainable public debt, respect of commitments under excessive deficit procedure (EDP), track record of access to capital markets on reasonable terms, sustainable external position, and the absence of bank solvency problems that would pose systemic threats to the stability of the euro area banking system). The beneficiary country will be obliged to respect the eligibility criteria after the PCCL is granted.
- Enhanced conditions credit line (ECCL) – Access open to all euro area Member States whose general economic and financial situation remains sound but do not comply with some of the eligibility criteria for accessing a PCCL. The beneficiary ESM Member will be obliged to adopt corrective measures aimed at addressing such weaknesses and avoiding any future problems in respect of access to market financing, while ensuring a continuous respect of the eligibility criteria which were considered met when the credit line was granted.

➤ E10 –What is the procedure for granting precautionary financial assistance?

As with other forms of assistance, a request must be addressed to the Chairperson of the ESM Board of Governors, who will then entrust the European Commission in liaison with the ECB to assess whether the potential beneficiary country meets the required conditions and to evaluate its financing needs. An MoU will be negotiated and signed by the European Commission and an FFA detailing the financial terms and conditions of the assistance will be prepared by the Managing Director and adopted by the Board of Governors.

➤ E11 – How will a credit line be activated?

A credit line will be activated at the initiative of the beneficiary ESM Member. The Member will have the flexibility to request the draw-down of funds at any time during the availability period of the credit line according to the agreed terms. It will inform the ESM at least a week in advance of its intention to draw funds, depending on the intended size.

➤ E12 – Will beneficiary countries be subject to enhanced surveillance?

Yes, when an ECCL is granted or a PCCL drawn, the ESM Member will be subject to enhanced surveillance by the European Commission for the availability period of the credit line. The scope of surveillance will include information regarding the beneficiary country's financial condition and developments in its financial system. On a request from the European Commission, the beneficiary ESM Member will also be required to carry out stress tests or sensitivity analyses to assess the resilience of the financial sector to various shocks and be subject to regular assessments of its supervisory capacities over the banking sector in the form of a peer review carried out by the relevant ESA. In addition, the beneficiary country will be obliged to carry out and report on a comprehensive independent audit of the accounts of the general government conducted in coordination with national supreme audit institutions, aiming at assessing the reliability, completeness and accuracy of these public accounts for the purposes of the excessive deficit procedure.

The European Commission will conduct, in liaison with the ECB and the European Supervisory Authorities as needed, and where appropriate the IMF, regular review missions in the ESM Member under surveillance to verify the progresses made in the implementation of the adopted measures. It will communicate, every quarter, its findings to the Board of Directors and assess whether further policy measures are needed.

- E13 – Will there be an assessment of the adequacy of the credit lines?

The adequacy of the precautionary financial assistance will be assessed on a proposal from the ESM Managing Director based on the findings of the review mission or, where a PCCL has been granted but not drawn, the results of the regular EU multilateral surveillance procedure. The Board of Directors will decide on the basis of this proposal whether the credit line should be maintained.

### **Primary Market support facility**

- E14 - What is the objective of the ESM's Primary Market Support Facility (PMSF)?

The ESM may engage in primary market purchases of bonds or other debt securities issued by ESM Members to allow them to maintain or restore their relationship with the dealer/investment community and therefore reduce the risk of a failed auction. It would also serve to increase efficiency of ESM lending.

- E15 – Which countries could benefit from ESM primary market intervention?

Bond purchase operations in the primary market could be made in complement to regular loans under a macroeconomic adjustment programme or to drawdown of funds under a precautionary programme. This instrument would be used primarily towards the end of an adjustment programme to facilitate a country's return to the market.

- E16 –Would conditionality be attached?

Conditions would be those of the macroeconomic adjustment programme or precautionary programme.

- E17 –What is the relation between the ESM's primary market intervention and the ECB's Outright Monetary Transactions (OMT)?

As announced by ECB President Mario Draghi on 6 September 2012, Outright Monetary Transactions, i.e. is the purchase of euro area sovereign bonds on the secondary market by the ECB, will be considered for future cases of EFSF/ESM macroeconomic adjustment programmes or precautionary programmes, provided that they include the possibility of EFSF/ESM primary market purchases. OMT may also be considered for Member States currently under a macroeconomic adjustment programme when they will be regaining bond market access.

- E18 – What is the procedure for using PMSF for the disbursement of a loan?

If an ESM Member requests the use of a PMSF when requesting a loan, the same procedure as in the case of stability support loans applies (see question D2). If an ESM Member requests the use of PMSF after having entered into a loan facility, the ESM's Managing Director will prepare a proposal within the overall financial limit of the loan facility whether to grant the PMSF, to be adopted by the Board of Governors. The Managing Director will then prepare a proposal for a revised financial assistance facility agreement (FFA) covering the financial terms and conditions of the PMSF, to be adopted by the Board of Directors.

An ESM Member to which a PMSF has been granted should inform the Managing Director of its intention to have one or several tranches under a loan facility disbursed via primary market purchase. The Board of Directors will allow the disbursement after having received the last report by the European Commission in liaison with the ECB on the compliance by the beneficiary Member with the policy conditionality attached to the assistance facility.

In the case of an ESM Member to which a stability support in the form of a credit line has

been granted, that Member should inform at least a week in advance, or as otherwise agreed in the facility agreement, the ESM Board of Directors of its intention to draw down funds via primary market purchase. The Managing Director will agree with the beneficiary ESM Member the detailed modalities for carrying out the PMSF. This agreement will be updated regularly with a view to taking into account the evolution of the market situation of the beneficiary ESM member.

➤ E19 – How will the primary market purchases be implemented?

Primary market purchases will as a rule be conducted at market price. The manner of implementation will depend on the issuance approach taken by the ESM member:

- *Via a participation in auctions*, at the average weighted price of the auction. The amount purchased by the ESM will, as a rule, be limited to 50% of the final issued amount. This proportion will, however, be increased if market bids at acceptable prices are insufficient, with a view to ensuring that the amount sold by the beneficiary ESM Member is equivalent to at least half of the originally targeted amount.

or

- *Via participation in syndicated transactions*, at the re-offer price. The amount purchased by the ESM will, as a rule, be limited to 50% of the final issued amount. This proportion will, however, be increased if the order book is insufficient, with a view to ensuring that the amount sold by the beneficiary ESM Member is equivalent to at least half of the originally targeted amount.

➤ E20 – Would the ESM carry out the primary market purchase if there was insufficient demand from private investors?

No, the primary market purchase would not be carried out if the ESM's Managing Director concludes that the participation of private investors would be insufficient or if the rate would be excessively above the ESM funding rate. Where appropriate, the purchase of bonds would then be replaced by a regular draw-down of funds.

➤ E21 –What would the ESM do with the bonds purchased?

Once purchased by the ESM, securities could be

- resold to private investors when market conditions have improved
- held until maturity
- sold back to the beneficiary ESM Member
- used for repos with commercial banks to support liquidity management of the ESM

## Secondary Market Support Facility

➤ E22 - What is the objective of ESM's Secondary Market Support Facility (SMSF)?

The Secondary Market Support Facility aims to support the good functioning of the government debt markets of ESM Members in exceptional circumstances where the lack of market liquidity threatens financial stability, with a risk of pushing sovereign interest rates towards unsustainable levels and creating refinancing problems for the banking system of the ESM Member concerned. An ESM secondary market intervention is intended to enable market-making that would ensure some debt market liquidity and incentivise investors to further participate in the financing of ESM Members.

➤ E23 – Which countries would be eligible for ESM secondary market intervention?

Secondary market support could be provided for ESM Members under a macroeconomic

adjustment programme and also for non-programme Members whose economic and financial situation is fundamentally sound, as determined by respecting eligibility criteria (sustainable public debt, respect of commitments under excessive deficit procedure (EIP), track record of access to capital markets on reasonable terms, sustainable external position, and the absence of bank solvency problems that would pose systemic threats to the stability of the euro area banking system).

➤ E24 –Would conditionality be attached?

For countries under a macroeconomic adjustment programme, the conditionality of that programme applies. For ESM Members outside of a macroeconomic adjustment programme, an MoU detailing the policy conditions would be negotiated with the ESM Member concerned by the European Commission in liaison with the ECB.

➤ E25 –What would be the procedure to activate secondary market support?

The procedure would be initiated by a request from an ESM Member to the Chairperson of the Board of Governors, who will entrust the ECB to assess whether there are exceptional market circumstances and whether there is a risk to the financial stability of the euro area as a whole or of its Member States. In addition, the European Commission, in liaison with the ECB, will determine whether the Member's public debt is sustainable and assess its financing needs. On the basis of a proposal by the Managing Director, the Board of Governors will make a decision whether to grant secondary market support. For non-programme countries, an MoU will then be negotiated and signed. The Managing Director will then prepare a financial assistance facility agreement (FFA), specifying the financial terms and conditions under which the secondary market purchases are to be conducted, to be adopted by the Board of Governors.

➤ E26 –Will there be any caps on the volume of intervention?

Yes, the Board of Directors will establish pro-tempore intervention caps for the implementation of SMSF.

➤ E27 –What would ESM do with the bonds purchased?

As with purchases in the primary bond market, securities purchased by ESM on the secondary bond markets could be either resold to private investors when market conditions have improved, held until maturity, sold back to the beneficiary country or used for repos with commercial banks to support ESM's liquidity management.

➤ E28 –How will the ESM buy on the secondary markets?

A technical sub-committee will be established to decide on the implementation of secondary market interventions. The European Central Bank (ECB) will act as fiscal agent for the ESM.

➤ E29 – Are you considering pre-funding to be equipped for secondary market purchases?

This is not an issue currently under consideration.

➤ E30 –Will the ESM take over bonds previously bought by the ECB?

This is not intended at this stage.