The ESM: From unexpected start-up to innovative international financial institution

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I want to tell you the inside story of a small group of people – 12 to be precise – that started a public sector start-up in 2010, and of how that start-up developed into an institution that played a key role in keeping the Eurozone intact during the sovereign debt crisis. An institution that is one of the biggest issuers of euro-denominated bonds globally, while purposefully remaining **lean and agile**.

And I will describe how we incorporated **modern infrastructure and technological innovation to build a first-in-class, low cost public service, and** what we have planned for the **future in terms of innovative technological solutions.**

Traditionally, public sector institutions have been seen as bureaucratic and slow-moving, but establishing a new “start-up” institution, with a mandate to solve crises rapidly, disrupts this idea and allows for the shaping of an institution that is modern, attractive and can be ahead of others.

The story starts nine years ago, in May 2010. Europe was still feeling the shockwaves of the global financial crisis that started in the US in 2007. This fed into a second crisis, when the euro area was forced to deal with its excessive sovereign debt load, real estate bubbles in several countries, and unprecedented turmoil in the markets.

The year 2010, as you may remember, was a turbulent year, when the unexpected happened. A Eurozone country, Greece, lost market access. It was the first EU country to experience a full-blown crisis. Investor confidence quickly eroded, causing the yields on Greek sovereign bonds to rise to unsustainable levels.

Europe did not have the institutional infrastructure to manage this. No one had imagined that a Eurozone member could lose access to financial markets, and consequently, find itself on the brink of a sovereign default which would imply leaving the euro.

Such a scenario would have caused an economic disaster for the country in question, and with potential contagion, could have threatened the existence of the euro as a currency.

To deal with the Greek crisis, the leaders of the Eurozone countries had come up with an ad-hoc solution: a package of bilateral loans for Greece, with additional assistance from the IMF.

But with the debt crisis spreading to other countries in the euro area, European markets were imploding, and further steps were needed.

While Greece was initially financed by bilateral loans from Member States, to avoid contagion and support other countries if they lost market access, a bigger firewall was needed. Over the course of 2 months, May and June 2010, a billion-euro rescue fund emerged. The European Financial Stability Facility, or EFSF, was created.

We aimed at creating a very lean and modern setup, so we sought help from the best in the market. The German Finance Agency and the European Investment Bank aided us with our front office operations and debt distribution, our back office, accounting and administration.

We were a p**rivate company under Luxembourgish law** with a **firepower of €440 billion, created in less than 8 weeks by its 12 first employees**. The expectation, at the time, was that the fund would never be used. It would just be in place for three years to calm the markets.

However, that’s not how it turned out. Ireland’s budget problems deteriorated to such a degree that the Irish government requested financial assistance from the EFSF in November 2010.

This meant that the EFSF would have to quickly issue its first bond on the markets, in order to finance a loan for Ireland. We had a provisional AAA rating from all three major rating agencies, but as a start-up, we were completely unknown to investors.

We quickly organized a series of roadshows to present ourselves to them and explain how our bonds were backed by guarantees of the euro area member states. The success of our first bond exceeded all expectations**: an orderbook of €45 billion, 9 times oversubscribed.** This was **a huge success for a company that was just 7 months old.** We were on our way.

However, it was not a time to celebrate – spreads from the weakest Eurozone countries kept widening to unsustainable levels, and Portugal and Greece would soon come knocking on our door. It became clear that the EFSF – a temporary institution with a life-span for new loan disbursements of only three years – was not sufficient to safeguard financial stability and protect the Eurozone. A permanent and effective solution was needed.

So, in February 2012, the countries of the euro area signed an intergovernmental treaty creating the European Stability Mechanism – ESM. This rescue package closed an institutional gap in the initial concept of EMU. Before the crisis, there was no “lender of last resort” for countries.

Without the creation of the rescue funds, former programme countries such as Greece, Ireland and Portugal would probably have had to leave the monetary union. And Europe would look different today.

Euro area member states contributed €80 billion for this purpose, which serves as a backing for the bonds that ESM issues. The ESM has the largest amount of paid-in capital among all international financial institutions in the world. Euro area leaders also agreed on an additional €620 billion in callable capital, to be contributed if required, giving the ESM a total subscribed capital base of over €700 billion.

Both the EFSF and ESM follow the same “cash for reforms” approach. Every single loan tranche is provided on the condition that a set of reforms is implemented by the beneficiary country. These are measures designed to boost economic growth, create jobs, and improve competitiveness.

The EFSF and ESM have provided assistance to five countries: Ireland, Portugal Greece, Spain, and Cyprus, disbursing a total of €295 billion in loans.

Today, Portugal, Ireland, Spain and Cyprus are success stories as they are experiencing high growth and rapidly falling unemployment rates. And they can easily refinance themselves on the market again. Greece is also on the right track, as long as it continues its reform path.

Over the years, the ESM has become a mature, trusted and respected institution. In the early days, people didn’t even know our name – the press usually referred to us as “the Eurozone’s rescue fund”.

Today, the ESM is a major player: we are one of the largest euro-denominated bond issuer in our peer group, that is Sovereigns, Supranationals and Agencies. We have €300 billion worth of outstanding bonds. This year we are planning to raise over €32.5 billion from investors. And because of our strong credit ratings, we can do so at very low costs.

These favourable financing conditions are passed on to the beneficiary countries. The low interest rates lead to considerable budgetary savings for the respective countries: in the case of Greece the budget saves close to €12 billion annually in interest payments, which is more than 6% of Greek economic output.

To fulfil our mission well, we didn’t want the ESM to be burdened by bureaucratic procedures. As a crisis resolution mechanism, it is in our mandate to be flexible in difficult situations. We had to be fast, lean and modern. We entrenched it in our institutional mission, vision and values. **Technology became part of our DNA**.

I think it is safe to say that these principles made it possible to set up a modern and efficient organisation. Looking back at those early days, I believe that our achievements have vindicated the path we had chosen.

Let me take give you a few examples.

First, we aimed to keep a **lean model**. We have kept the strategic functions in house, like funding, economics, investment and key operational and support functions and we outsourced non-strategic functions as much as we could. We were one of the first financial institutions worldwide to use a fully cloud-based trading system.

We were the first to fully outsource our corporate IT. And we were the first European Institution to be a full HR and accounting cloud user. We did not see a need to run a single server at our facilities and we still don't. This allows us to run a €400 billion balance sheet with a staff of just 190 people.

Second, we started more than five years ago **engaging in fintech**. We were the first public institution that was part of a fintech circle in London and we have connected with more than 100 fintech firms so far.

We wanted to find out where processes and models of the financial sector and financial markets had the potential to be redesigned or rebuilt in a new way. We also looked at so-called disruptive technologies, such as block chain based debt distribution. I am personally passionate about this field.

We created a volunteer group of staff, so-called ESM 4.0, where staff is engaged in looking for innovative solutions. They do this in their free time and great new solutions are generated. For example, two engaged staff members, after 1 hour of programming came up with a problem solving solution for novation of contracts in the back office, gaining time and avoiding errors.

Third, we wanted to **leverage new technology to navigate capital markets**. The ESM is actively pursuing the use of data analytics. Innovative technology allows the ESM to better navigate markets, deliver better value for shareholders, and better meet investor needs.

One example of how we have are using fintech is our customized market intelligence application for analysing the trades on the bond market. A well-functioning and liquid bond market is extremely important for our investors and therefore for us. Our application starts with data from the primary market and also comprises data on trades in the secondary market. We have built a proprietary deep data market intelligence tool.

The tool contains more than two million data points. We trace every single trade of our bonds on the secondary market. This means more than 110 bonds and also all our bills, in other words, money market paper. That is a very big data set and it contains a lot of information that we analyse. We get the data from our market group that is composed of 41 banks.

The banks give us the data regarding the turnover in our bonds, transaction by transaction. We then use the algorithm we have developed ourselves to evaluate the data.

For example, it allows us to understand how the trading in our bonds evolves and changes over time. We know which investor groups from what regions are buying or selling our bonds. We get information on typical quantities that are traded in specific sectors or regions. From this information, we draw knowledge that is typically categorised as “market sentiment”.

We are now able to underpin such a market feeling for our bonds with hard data and this allows us to support liquidity in the secondary market.

This was developed fully in-house, with the aid of our quantitative analyst Martin Hillebrand. We have application developers, programmers and quant experts. For us, this information about the market is very important as it gives us unique insights for our issuance strategy and tactics.

Four, we want to use new technology to be **more transparent.** Fulfilling a recommendation from the latest evaluation of past EFSF and ESM financial assistance, we are currently working on a public database for our website. The programme database will provide macroeconomic and financial indicators, including projections, programme conditionality clauses and their reviews, as well as relevant lending data. While the presentation on our website will look clean and easy to apprehend, the real innovation is under the technological bonnet.

Finally, and potentially the biggest innovative project I'd like to speak to you about, is the initiative of a **European debt issuance platform** for public institutions. Let me first tell you about the rationale behind this project.

The primary bond markets infrastructure looks today as it looked in the 1990s. People still work on the phone, personal contacts between funding staff and banks and their "market feeling" play a major role. There are many system breaks in the communication, data, and settlement processing. The book-building process is rather inefficient.

The idea would be to build a stable and efficient chain of processes for the entire issuance process on the European bond market.

A single and synchronized system from the front to the back end that would make the issuance process for issuers, banks and investors much more efficient. That starts with the announcement of the bond deal and it would continue up to the settlement of the entire transaction.

This would increase standardisation in the currently fragmented market for public debt in the EA and finally ease the access of investors to the primary market. With this new service, we would get a deeper and more liquid market.

This would also lead to greater resilience, which is a big advantage in times of crisis or when the markets are affected by political tensions. This in turn would lead to more stability in the markets. Such a solution would be an important contribution to the EU's capital markets union. And it would strengthen the role and geopolitical independence of the euro in the international financial system.

Has our innovation roadmap always been perfect? The answer is a resounding no. As a first mover in cloud, we experienced a lot of "teething problems," sometimes our demand went beyond what was technologically was possible. European data storage and privacy have become bigger topics, cyber security risks are becoming more important and, like any institution, we face adaption problems and cultural resistance. But I still believe the technological benefits outweigh disadvantages.

So what is next for the ESM?

At the Euro Summit in December 2018, it was agreed that the ESM should be entrusted with new tasks. The leaders of the euro area member states aim to expend our mandate in several important areas.

First, the ESM will take on the role of a backstop in bank resolutions in the Banking Union. This backstop would be used when the resources of the Single Resolution Fund are insufficient. If the ESM has to provide money to the SRF, the Fund will claim this money back through contributions from European banks and pay back the ESM within three to five years. By 2024 at the latest, the backstop should be fully operational.

Second, the ESM will play a stronger role in future financial assistance programmes. In collaboration with the European Commission, the ESM will design, negotiate and monitor such programmes.

In the future, the Commission and the ESM will jointly develop a debt sustainability analysis for programme countries. In addition, the ESM can facilitate future discussions between creditors and a government on a possible debt restructuring, if this is desirable and useful.

The intention is not to have more debt restructurings but to have more transparency and predictability.

Third, the ESM's toolbox is currently being reviewed. Overall, the ESM has various financial instruments. So far, only two have been used: long-term loans under an ESM adjustment programme, disbursed to Greece, Ireland, Portugal and Cyprus, and one loan to Spain to recapitalise the banking sector.

We also have precautionary credit lines in our "toolkit" but they have never been used. The Euro Summit decided to make the ESM precautionary credit lines more efficient and easier to use, without attaching stigma for the requesting country.

The fact that the leaders of the Eurozone countries entrusted us with carrying out these important new tasks is a measure of how far the ESM has progressed since our humble beginnings in 2010. We hope the political endorsement of the ESM reform will be finalised by end of June 2019. It will then need to go through national parliaments.

We hope to continue to contribute to the success of the euro area and the prosperity of its citizens. This has been our mission from day. I believe that with the aid of modern technology, as well as innovative and creating thinking, we will be better prepared to face the challenges of the future. Time will tell if I am right, but one thing I can promise you is that we will remain true to that objective.

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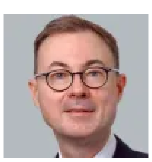

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