27 November 2017

European Stability Mechanism

High Level Principles for Risk Management

Preface

On 24 June 2011, the European Council decided to establish a permanent crisis resolution mechanism – the European Stability Mechanism (ESM) – to perform the following activities:

a) provide loans to euro area member states in financial difficulties
b) issue bonds or other debt instruments on the market to raise the funds needed
c) perform operations in the primary and secondary Euro sovereign debt markets
d) act to execute assistance in the context of a precautionary program
e) finance recapitalisations of financial institutions through loans to governments including in non-program countries.

In December 2012, the European Council proposed to extend the use of activity e) to direct recapitalisation.

For the benefit of ESM Members, the ESM uses a Diversified Funding Strategy to ensure access to broad funding sources and enable it to extend financial assistance packages to ESM Members, and in some circumstances institutions[1] in ESM Members' jurisdictions, under various market conditions. Flexibility is achieved in applying a diversified funding strategy.

Financial assistance from the ESM will in all cases be activated on a request from an ESM Member to the Chairperson of the ESM's Board of Governors. Loans to ESM Members will enjoy preferred creditor status in a similar fashion to those of the IMF, whilst accepting preferred creditor status of the IMF over the ESM (except for countries under a European financial assistance program at the signing of the ESM Treaty).

The ESM is an intergovernmental organisation under public international law. The ESM has authorised capital of ca. EUR 700 billion, of which, ca. EUR 80 billion is paid-in, pursuant to the adapted ESM Treaty effective 13 March 2014. ESM has a maximum lending capacity of EUR 500 billion. The paid-in capital is invested according to an approved strategy, reflecting due caution and purpose.

The activities of ESM and its various instruments are described in separate documents and include the basic purpose and principles of engagement.

The High Level Principles for Risk Management are the governing part of a detailed documentation, for the use of the ESM to translate the principles in a comprehensive risk policy.

[1] "Institution" is defined in Article 1(1) of the European Stability Mechanism Guideline on Financial Assistance for the Direct Recapitalisation of Institutions ("DRI Guideline"). The circumstances under which ESM can provide financial assistance to such institutions are limited to those contained in the DRI Guideline.

1 Introduction

1.1 Purpose

By this High Level Principles for Risk Management ("High Level Principles"), the Board of Directors defines the main principles that apply to identifying, measuring, mitigating, following up and reporting the risks associated with activities conducted by the ESM.

1.2 Scope and applicability

The High Level Principles set the minimum standards and do not limit the responsibility for risk management.

The High Level Principles are complemented by the Risk Policy, which shall be approved by the Board of Directors and specify technical provisions on risk management rules and procedures.

The High Level Principles and the Risk Policy define the risk management framework of the ESM, which shall be shared, understood and applied by the members of the Board of Directors, the Managing Director and the members of staff in conducting the operations of the ESM.

ESM applies elements of its High Level Principles and the Risk Policy to the provision of financial support to ESM Members, including eligible institutions, to the extent that they do not cover, in the case of ESM Members, counterparty risk and, in the case of institutions, equity risk and credit risk inherent to the decision to grant financial assistance to directly recapitalise a specific institution. As such, financial assistance in line with the purpose of ESM is granted to ESM Members, including eligible institutions, experiencing or threatened by severe financial problems, if indispensable to safeguard the financial stability of the euro area as a whole and of its member states.

2 Glossary

The following terms and definitions apply:

- **Risk** is the adverse (financial and non-financial) effect of uncertainty on the objectives of the organisation.
- **Risk aggregation** is the sum of all risks within the organisation.
- **Risk analysis** is the process to understand the risk and its evolution over time.
- **Risk appetite** is the amount of risk that the organisation is willing to pursue or retain.
- **Risk assessment** is the overall process of risk identification and risk analysis.
- **Risk evaluation** is the process of comparing results of risk analysis with risk criteria to determine whether the risk and its magnitude are acceptable or tolerable.
- **Risk identification** is the process of recognising and describing risks.
- **Risk management framework** includes components that provide the foundation and organisational arrangements for designing, implementing, monitoring, reviewing and continually improving risk management throughout the organisation. The risk management framework of the ESM is defined by the documents "The High Level Principles for Risk Management" and the "Risk Policy" and internal risk policies derived from, and consistent with, these documents.
- **Risk management** is the set of activities spanning risk assessment, risk evaluation and risk reporting.

- **Risk policy** is a document detailing the technical implementation of risk management within the organisation.
- **Risk manager** is a person who by virtue of expertise or authority has a leading role for the risk management process.
- **Risk profile** is the overview of the total risk by types of risk.
- **Risk reporting** is the communication of relevant risk facts to decision makers and enables decision makers to make informed decisions on risk.
- **Business function** is an organisation unit that forms a logical grouping of business processes and expertise.

3 Principles

3.1 Risk appetite

The ESM shall follow a prudent approach to risk-taking in order to limit potential losses and to ensure continuity in fulfilling its mandate and meeting its commitments.

The targeted risk appetite shall preserve the ESM's funding capacity, ensure the highest creditworthiness and avoid unexpected capital calls. The risk appetite shall be detailed in the Risk Policy.

The risk appetite is set out in the Risk Policy and detailed in the Annex to the Risk Policy. It covers all financial and non-financial risks of the ESM as described in Chapter 5 of this document, including both on- and off-balance sheet items.

The risk profile shall be defined by a set of limits applicable to curtail all types of risks within risk appetite.

The ESM does not aim to generate profit on financial support granted to beneficiary member states and shall not provide incentives for speculative exposures of its investment portfolio.

3.2 Risk culture

Risk culture is the combined set of individual and corporate values, attitudes, competencies and behaviour that determine ESM's commitment to and style of risk management. Main components shall include:

a) Staff at all levels shall clearly understand their responsibilities with respect to risk management.
b) The ESM shall apply the 'four eyes' principle requiring more than one person to be involved to complete a task. The ESM shall also adopt procedures with clearly drawn lines of authority, segregated powers and duties, and appropriate checks and balances across the organisation.
c) Risk management activities across the organisation shall be carried out by sufficient number of qualified staff with necessary experience, technical capabilities and adequate access to resources. Staff involved in risk management activities must act as whistleblowers when necessary.
d) Management shall emphasise high ethical standards at all levels and shall send a consistent message to the whole organisation that is fully supportive of the risk management framework through their actions and words.

3.3 Risk measurement

All risks shall be managed using the measurements that are most appropriate for the management and control of the respective types of risk. These measurements shall be defined in the Risk Policy.

The ESM shall apply multiple risk measurements for each type of risk, capture both current and forward looking aspects, and use both quantitative and qualitative information to avoid overreliance on a single risk measurement. This applies to on- and off-balance sheet items.

Regular risk measurement shall be supplemented by stress tests and scenario analysis to identify high-risk areas and to evaluate the combined effects of financial and non-financial shocks.

3.4 Continuous improvement

The ESM shall continuously improve the management of risk. Staff at all levels shall seek to achieve changes in processes in order to improve efficiency and quality of the ESM risk management on a day-to-day basis.

The ESM shall annually conduct a risk and compliance framework review in order to (re)assess the current state and progress of the risk management, and to identify measures for improvement.

3.5 Approval process for new tools and instruments

Introducing new tools or instruments or significant changes to existing ones, shall follow an internally approved and well-documented “New Tool and Instrument Approval Policy”.

The Risk Department shall have a prominent role in the process of approving new tools or instruments or significant changes to existing ones. The Risk Department shall ensure compliance with this process whenever appropriate.

Analysis of new tools shall include an assurance that the organisation possesses adequate internal risk tools and expertise to understand and monitor the risks associated with them. The analysis shall include the identification of conflicts of interest related to new tools and instruments.

4 Governance

4.1 First line of defence – Direct responsibility of management and control of risk

Departments and business functions assume direct responsibility for the day-to-day management of risk and for the design and operation of effective internal controls. All staff are responsible for ensuring that risks relating to their operations are identified, followed up and reported to the Risk Department.

Breaches of limits shall be immediately reported to the competent authority according to modalities detailed in the Risk Policy.

4.2 Second line of defence – Enforcement and oversight

The Board of Directors shall be accountable for the adequacy of the ESM’s risk management framework comprising both the High Level Principles and the Risk Policy.

a) The Board of Directors shall approve the Risk Policy upon proposal of the Managing Director and the Chief Risk Officer.
b) The Board of Directors shall specify the risk appetite of the ESM within the Risk Policy.

c) The Board of Directors shall be periodically informed on the state of the internal control framework, the state of the implementation of the risk management framework, of the aggregate figures of exposures and of violations of the risk management framework, if they occurred. Further, the Board of Directors shall be periodically informed on the decisions and actions to mitigate risk taken when breaches occurred.
d) The Board of Directors shall establish a risk committee to advise the Board of Directors on the overall current and future risk appetite and strategy and assist the Board of Directors in overseeing the implementation of that strategy by the Managing Director. The Board of Directors shall retain overall responsibility for risks.

The Managing Director bears full accountability for the implementation and functioning of the risk management framework, adequate reporting to the Board of Directors and Board Risk Committee and for further developing the Risk Policy.

The Risk Department exercises central oversight of risk and ensures the comprehensiveness and consistent implementation of the risk management framework by all business functions. The Risk Department shall be responsible for:

a) acting as an independent function of the ESM
b) developing and maintain a regular inventory of the risks borne by the ESM
c) identifying, assessing and proposing alternatives to mitigate the overall risks borne by the ESM
d) reporting of risks in a consistent way to Management and the Board of Directors putting forward its own judgment
e) validating monitoring tools and methodologies, and ensures their consistent implementation
f) implementing an appropriate early warning system, assessment and escalation of limit breaches, and shall recommend countermeasures to the Managing Director or staff concerned
g) fostering a risk culture throughout the whole organisation and lead the work of the Internal Risk Committee.

The Chief Risk Officer is the head of the Risk Department ("Head of Risk") and is a direct report to the Managing Director. The Chief Risk Officer is responsible and accountable for informing the Managing Director on all risks to ensure enforcement and oversight. The Managing Director, as Chairman of the Board of Directors, shall report the enforcement and oversight related information to the Board of Directors. The Chief Risk Officer shall:

a) have roles and responsibilities independent of and segregated from other executive functions and business line responsibilities
b) have access to all information necessary to evaluate risk
c) be also prominently part of the process for investment decisions and approval of new products, but is independent from the First Line investment decisions
d) also report and have direct access to the Board of Directors and its risk committee without impediment. Beyond periodic reporting, the Chief Risk Officer shall have the ability to engage with the Board of Directors.

The Internal Risk Committee is composed of management board members with a reasonable representation across business functions. Representatives of the ECB and the European Commission may participate in the Internal Risk Committee, if it discusses early warning system matters, and will be invited for IRC meetings requiring key decisions in that respect, or in accordance with the Terms and Conditions of Capital Calls for ESM.

a) Members of the Internal Risk Committee shall act as a risk manager in their business function.
b) The Chief Risk Officer shall be the chairperson of the Internal Risk Committee.
c) The Internal Risk Committee shall translate the risk appetite into the Risk Policy which is approved by the Board of Directors.
d) The Internal Risk Committee shall assist the Board of Directors in ensuring the adequacy of the ESM's internal limit structure and limit setting, and in providing recommendations on changes of the internal limit structure.
e) The Internal Risk Committee shall provide recommendations on identification of relevant risks, and on the suitability of methods to monitor and manage them.
f) The Internal Risk Committee shall oversee the conduct on a periodic basis of a risk and compliance framework review and shall report the result to the Managing Director.
g) The Internal Risk Committee shall have authority to suggest to the Managing Director to undertake investigations on risk management (including outsourced activities) through either internal or external audit teams.

4.3 Third line of defence – Independent assurance

Internal Audit is an independent function and shall be responsible for providing to the Board of Directors a reasonable assurance that the risk management function is operating properly and efficiently. Internal Audit shall report to the Managing Director and shall have also direct access to the Board of Auditors on issues related to risk management.

The external auditor performs its statutory duties, conforming with applicable law and content of the ESM Treaty, including risk.

The Board of Auditors is an independent function appointed by the Board of Governors and shall draw up independent audits in accordance with Article 30 of the ESM Treaty and Article 24.4 of the By-Laws.

5 Types of risks and mitigations

5.1 Financial risks

Credit risk is defined as the potential for loss arising from inability of a counterparty, issuer, insurer, or other obligor to fulfil its contractual obligations for full value when due. Counterparty risk is considered a particular form of credit risk and derives from the lending and support operations to beneficiary member states, investment of paid-in capital, placement of possible excess liquidity, and hedging operations. Issuer risk is also a particular form of credit risk and derives from investment of paid-in capital and excess liquidity in securities.

a) Counterparty and issuer risk shall be minimised by implementing rules, procedures and limits in respect of eligible issuers and counterparties of high credit standing and using other mitigation techniques that management consider appropriate (e.g. guarantees, collateral and/or adopting continuous linked settlements).

b) On the derivative contracts, the ESM shall limit itself to counterparties complying with high credit standards as detailed in the Risk Appetite Statement of the Annex to the Risk Policy. Further, the ESM shall enter into such collateral arrangements as the Managing Director deems necessary or appropriate in the interests of the ESM. Likewise, excess liquidity shall be invested in, or collateralised with, well rated paper according to criteria detailed in the Investment Guidelines.

Settlement risk is defined as the potential for loss arising from the failure of one or more counterparties to settle transactions in an exchange-for-value model when settlement of various legs of a transaction happens at different times. Settlement risk shall be minimised by adopting delivery versus payment or novation procedures via clearing houses, and/or adopting continuous linked settlements where appropriate.

Credit concentration risk is defined as the potential for loss arising from undiversified, correlated exposure to a particular group of counterparties e.g. in a sector, region, country or zone of countries. Credit concentration risk shall be minimised by limiting exposures by different group categories for the investment of paid-in capital and reserves. Following its mandate, the ESM shall accept credit risk concentration from financial assistance to beneficiary member states.

Funding liquidity risk is defined as inability to raise money in a timely manner. Due to this, the ESM could be unable to settle obligations when they are due and be held in breach of its obligations. Funding liquidity risk shall be minimised by undertaking a diversified funding strategy, maintaining multiple credit lines and investing capital in high credit quality liquid assets that can be used to raise cash to meet obligations as they fall due. In exceptional circumstances, e.g. loss of market access to funding, and in order to avoid or limit unexpected capital calls, the ESM may use liquidity from investment portfolios to meet its payment obligations to ESM creditors.

Market liquidity risk is defined as the potential for loss arising from a position that cannot easily be unwound or offset at short notice without significantly negatively influencing the market price because of inadequate market depth or market disruption. Market liquidity risk shall be minimised by investing capital in high credit quality liquid assets, ensuring ESM does not hold a significant proportion of a security issuance and adopting adequate measurements that allow the timely detection of liquidity deteriorations.

Liquidity concentration risk is defined as the potential loss arising from concentrations in assets and liabilities as major sources of liquidity. A concentration in assets can disrupt an institution's ability to generate cash in times of illiquidity or reduced market liquidity for certain asset classes. A liability concentration (or funding concentration) exists when the funding structure of the institution makes the ESM vulnerable to a single event or a single factor, such as a significant and sudden withdrawal of funds or inadequate access to new funding. Liquidity concentration risk shall be minimised by securing credit lines and adopting a diversified funding strategy.

Interest rate risk is defined as potential for loss arising from adverse movements in interest rates. Main sources of interest rate risk include asset or liability repricing, triggered by covenants or market movements, yield curve shifts, and changes in the funding or lending spread. Interest rate risk shall be managed prudently, including with use of derivatives and in line with the risk appetite.

Foreign exchange risk is defined as the potential for loss arising from changes in the exchange rates. Foreign exchange risk shall be minimised with limited exposures to certain currencies, and managed prudently in compliance with the risk appetite.

Equity risk is defined as the potential for loss arising from changes in the price of equity instruments. Equity risk shall be restricted to that deriving from equity investments in direct recapitalisation instruments undertaken in accordance with the DRI Guideline.

Further risk mitigation techniques considered appropriate and coherent with the High Level Principles shall be specified in the Risk Policy.

5.2 Non-financial risks

Operational risk is defined as the potential loss, inability to fulfil the ESM's mandate or reputational damage resulting from inadequate or failed internal processes, people and systems or from external events. Operational risk includes physical or environmental risks. Operational risk losses lead to P&L write downs, external costs incurred as a consequence of the event, specific provisions following the risk event or pending losses.

a) The Risk Policy details processes, risk management tools and a control framework to ensure a very high level of control on the operational risks inherent to activities of the ESM. The ESM maintains business continuity plans and has resources dedicated to the oversight and management of specific types of operational risk such as fraud, risks pertaining to payment systems, and information systems security risks.

b) For outsourced activities, the ESM is aligned with best business practices on outsourcing within the financial sector, and implements methods and procedures compliant with those standards.

Reputational risk is the risk of loss and/or damage arising from a deterioration in ESM's reputation, reducing its access to the market, lowering of credit rating, loss of political capital, inability to attract suitably qualified staff and other similar consequences. This risk shall be mitigated by ESM undertaking its mandate in accordance with the highest professional standards, by having centralised co-ordination of external communication, by managing its risks prudently and by maintaining its high credit standing.

Political risk is the risk of loss and/or damage arising as a result of a single or multiple political events that impact the ESM's ability to perform its mandate (e.g. by reducing access to the market for funding). Political risk shall be managed principally by the ESM Board of Governors and closely monitored by the ESM Managing Director.

Legal risk is the risk of loss as a result of (a) inadequate or inefficient documentation, legal capacity, enforceability of national and international laws, (b) litigation against ESM or its assets and (c) non-compliance with the Treaty establishing the ESM, associated by-laws or any other applicable laws and contractual obligations. Legal risk is managed by obtaining review and advice from internal and external legal counsel to ensure ESM activities are in compliance with the law and supported by enforceable, robust contractual arrangements.

Compliance risk is the risk of loss and/or damage associated with the non-compliance with internal policies, procedures and guidelines as well as any external policies, regulations and directives which might govern the ESM. Compliance risk shall be mitigated by adopting appropriate internal procedures and/or using other mitigation techniques. The Code of Conduct, as part of the legal framework, defines the fundamental ethical principles to be assumed by the ESM's members of staff. These include e.g. the requirement regarding the members of staff's integrity and loyalty, guidelines for handling conflicts of interest, prohibitions on insider trading, restrictions on financial interest and rules regarding confidentiality, public statements and contacts with the media.

6 Reporting to the Board of Directors

The periodic risk reporting to the Board of Directors is inclusive of narrative sections explaining the risk profile evolution over the period under analysis. The risk reporting shall inform about risk exposures at aggregate level, and provide a summary of breaches to the risk limits with the action taken to cope with the risk breaches and provide assurance regarding the compliance with the risk management framework. The corresponding reporting requirements will be set in the Risk Policy.