

European Stability Mechanism



The reform of the European Stability Mechanism

This article seeks to explain the main aspects of the reform of the European Stability Mechanism, as agreed in principle by the leaders of the euro area member states. The article focuses particularly on the ESM's new mandate to act as the common backstop to the Single Resolution Fund, the reform of its precautionary lending instrument, the expansion of its role in country monitoring both in and outside of programmes, and the future treatment of debt sustainability issues, including the adoption of a revised euro area model collective action clause. By shedding light on the nature and context of these developments, the authors hope to dispel some misunderstandings about the content of this reform and contribute to a clearer understanding of what is at stake.

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Foreword



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This paper was completed before the onset of the current crisis caused by Covid-19. Its purpose, as explained in the authors' introduction, is to provide a guide to the changes already in the works for the European "firewall" and to the underlying policy objectives they were designed to meet. The current crisis has now added some sharp context for its readers. To help in the face of the pandemic, the ESM has been able to adapt its current instruments even without the long-awaited Treaty changes. We mobilised fast, were technically creative, and saw an outstanding level of cooperation and flexibility across the political and institutional landscape. We are proud to be considered part of a coordinated response, at least for the euro area, standing alongside the European Central Bank, the European Commission, and the European Investment Bank.

Yet there is a warning here. The one certainty about financial crises is that there will be another one. Europe must have the tools it needs both to look ahead and to meet the demands the next crisis will bring. There must be flexibility and technical innovation and intense cooperation not just when the next crisis arrives but in advance and in good time.

The reforms of the ESM, which the authors of this paper describe and analyse, are therefore essential. They were conceived and negotiated in the calmer economic waters before the current crisis. A huge amount of patient diplomatic work by policymakers and technical staff over a substantial period of time was required. It is still subject to parliamentary approval in our member states. This illuminating paper was written by two of the expert ESM legal counsel here in Luxembourg who worked on the reform package from beginning to end. I commend both it and the reforms themselves to you.

Introduction

A little over a year ago, the leaders of the countries of the euro area formally pledged to reform the European Stability Mechanism (ESM). At the Euro Summit of 14 December 2018, the Heads of State or Government of the euro area member states endorsed the ‘Term Sheet on the reform of the European Stability Mechanism’, including the anticipated changes to its founding treaty.¹ In December 2019, both the Eurogroup in inclusive format² and the subsequent Euro Summit reached an agreement in principle on this reform package, subject to the conclusion of national procedures.³ The anticipated reform of the ESM follows seven years of ESM financial assistance programmes, during which the ESM, together with its predecessor the European Financial Stability Facility (EFSF), provided almost €300 billion in financial assistance to five euro area member states. As of the beginning of 2020, all beneficiary countries have successfully exited their programmes and some have already started early repayment to the EFSF/ESM and other creditors, such as the International Monetary Fund (IMF).

The current ESM reform is a consequence of the institution’s evolution over the last seven years, and is stimulated in part by the recognition of the ESM’s positive contribution to past programmes. It aims to develop further the ESM’s role and position as the euro area crisis-resolution mechanism, while also refining the financial instruments that are part of the ESM’s toolkit and introducing new ones.

As customary with changes to the European financial stability architecture, the current ESM reform is not without controversy. However, some arguments made in the debate seem based on misconceptions as to the substance of the reform. This paper aims to help dispel some of those misconceptions by describing the main building blocks of the ESM reform. This includes explaining the introduction of single-limb collective action clauses (CACs), the broader involvement of the ESM in the design, negotiation, monitoring, and assessment of financial assistance operations, and the introduction of the common backstop to the Single Resolution Fund, all of which have entered the public discussion in different euro area countries.

¹ Euro Summit Statement (14 December 2018), www.consilium.europa.eu/media/37563/20181214-euro-summit-statement.pdf. Just prior to the summit, the Eurogroup had agreed the Term Sheet on the European Stability Mechanism reform on 4 December 2018, available at www.consilium.europa.eu/media/37267/esm-term-sheet-041218_final_clean.pdf.

² The Eurogroup is said to meet “in inclusive format” when the Ministers of Finance of the non-euro area EU Member States also participate.

³ Euro Summit Statement (13 December 2019), available at <https://www.consilium.europa.eu/en/press/press-releases/2019/12/13/statement-of-the-euro-summit-13-december-2019/>, and report by Mr. Mário Centeno (President of the Eurogroup) to Mr. Charles Michel (President of the Euro Summit), 5 December 2019, available at <https://www.consilium.europa.eu/nl/press/press-releases/2019/12/05/deepening-the-emu-president-centeno-s-report-to-the-president-of-the-euro-summit/>.

1. Revised ESM Treaty

The ESM is not a European Union (EU) institution but an intergovernmental organisation formed under public international law.⁴ The ESM was established by its own international treaty (ESM Treaty) in 2012, with the (currently, 19) euro area member states as its members.⁵ The ESM's predecessor, the EFSF, is a Luxembourg-based public limited liability company (*société anonyme*) established in 2010, at the height of the financial crisis in Europe, as a temporary crisis resolution organisation, with the then (17) euro area member states as its shareholders. The ESM has, after its creation, taken over the role of the EFSF as lender of last-resort.⁶

Elements of the reform package made changes to the ESM Treaty unavoidable. The Eurogroup initially endorsed the revised draft of the Treaty on 15 June 2019, only six months after the political agreement on the Term Sheet on ESM reform – swift progress, given the context.⁷ The Euro Summit of 21 June 2019 then welcomed the agreement on the revised ESM Treaty and invited the Eurogroup in inclusive format, and all relevant parties, to continue working on the full package of documents related to the ESM reforms.⁸ Further technical work was conducted to finalise the remaining legal documents such as guidelines, policies, and draft board resolutions. On 4 December 2019, precisely one year after the initial political agreement on the Term Sheet,⁹ the Eurogroup in inclusive format agreed in principle on the entire ESM reform package, subject to the conclusion of national procedures. During the Euro Summit of 13 December 2019, the Heads of State or Government noted the progress on ESM reform and stated that they looked forward to its continuation, together with work on some additional elements regarding the Banking and Capital Markets Union, and requested an update during the Euro Summit in June 2020, at the latest.

Without prejudice to further political developments and discussions on the strengthening of Banking Union as a whole, the agreement amending the ESM Treaty is scheduled to be signed by the euro area member states during the first half of 2020.¹⁰ After signing, ratification procedures will take place in each country. Assuming these are successfully completed within a standard timeframe, we expect that the updated ESM Treaty will enter into force somewhere between 12 to 18 months from the signing of the amending agreement. We note, however, that

⁴ In this respect, the suggestion by the European Commission to include an explicit reference in the amended ESM Treaty to the integration of the ESM into the EU legal framework was not supported by the euro area member states. Yet, the authors note that the ESM Managing Director has consistently indicated that in the future, at the right time and under the appropriate conditions, the ESM could be integrated into the EU legal framework, if so politically desired and agreed.

⁵ Euro area (and ESM) membership currently stands at 19 countries, following the accession of Latvia in 2014 and Lithuania in 2015. The “Treaty Establishing the European Stability Mechanism between the Kingdom of Belgium, the Federal Republic of Germany, the Republic of Estonia, Ireland, the Hellenic Republic, the Kingdom of Spain, the French Republic, the Italian Republic, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Grand Duchy of Luxembourg, Malta, the Kingdom of the Netherlands, the Republic of Austria, the Portuguese Republic, the Republic of Slovenia, the Slovak Republic and the Republic of Finland”, available at <https://www.esm.europa.eu/legal-documents/esm-treaty>.

⁶ While the Articles of Incorporation of the EFSF stipulate that it is no longer authorised to provide any new financial assistance programmes or loans after 30 June 2013, the company itself still exists. On its balance sheet are still (as assets) the loans made to Ireland, Portugal, and Greece before 30 June 2013 and (as liabilities) the bonds issued to fund those loans. EFSF bonds are covered by several-but-not-joint guarantees given by EFSF shareholders. While individual bonds may mature and be refinanced by new bonds, the total volume of EFSF bonds (and related guarantees) outstanding decreases over time in line with the repayment of EFSF loans. Currently, the last EFSF loan instalment is due for repayment in 2070, which is also when the EFSF's longest guaranteed bond matures.

⁷ The text of the revised ESM Treaty, including two new Annexes as agreed by the Eurogroup in inclusive format in June 2019, available at <https://www.consilium.europa.eu/en/press/press-releases/2019/06/15/economic-and-monetary-union-eurogroup-agrees-term-sheet-on-euro-area-budgetary-instrument-and-revised-esm-treaty>.

⁸ Euro Summit statement (21 June 2019), available at <https://www.consilium.europa.eu/en/press/press-releases/2019/06/21/statement-of-the-euro-summit-21-june-2019/>.

⁹ See footnote 3.

¹⁰ This paper was written in February 2020. The subsequent outbreak of the Covid-19 pandemic, and the focus on addressing its economic impact, led to euro area member states agreeing to postpone the signing of the amendments to the ESM Treaty.

the entry into force of the additional documents of the ESM reform package remains subject to further domestic decision-making by the euro area member states, as well as to internal and formal decision-making by the ESM governing bodies. In some countries, national procedures must precede any vote cast by the country's representative in the relevant ESM governing body on certain topics. Although we expect them to require some additional time, these national procedures tend to be much simpler and more expedient than the treaty ratification process.

The ESM Treaty, as amended by the amending agreement, provides the various building blocks for the ESM reform.



2. Common backstop to the Single Resolution Fund

The Single Resolution Fund (SRF) is the fund managed by the Single Resolution Board (SRB). The SRB is the central resolution authority within Banking Union ensuring an orderly resolution of failing banks. In a bank resolution case, the SRF may be used – where required – to ensure the efficient application of resolution tools and the exercise of the resolution powers of the SRB. The SRF is composed of contributions from credit institutions and certain investment firms in the Member States participating in Banking Union. The SRF will be built up gradually during the first eight years of its existence (2016–2023) to reach a target level of at least 1% of the amount of covered deposits of all credit institutions within Banking Union by the end of the transition period, which is 31 December 2023. As of July 2019, the SRF held €33 billion in contributions.¹¹ In spite of this, a credible backstop to the SRF was deemed necessary to complement this pillar of Banking Union and ensure financial stability.

Following protracted political discussions, the euro area member states agreed that the ESM will provide the backstop to the SRF on their behalf, to ensure the SRF's credibility and preserve financial stability. Non-euro area member states joining Banking Union are expected to participate in the backstop by providing parallel support. Following this agreement at the end of 2018,¹² over the course of 2019 the ESM, together with other relevant stakeholders, developed the revised ESM Treaty language and other documents needed to incorporate the common backstop into its toolkit of financial instruments.

The currently politically endorsed draft Article 18A of the revised ESM Treaty, together with the new Annex IV to the ESM Treaty, provides for this new financial instrument. The common backstop takes the form of a revolving credit line and differs significantly from the financial assistance instruments with which the ESM has been endowed thus far.

As a means of last resort, the common backstop will be activated to provide financing to the SRB¹³ once the SRF is depleted, to cover expenses incurred by the use of the SRF under Article 76 of the EU Regulation on the Single Resolution Mechanism¹⁴ (SRMR), including liquidity provision subject to adequate safeguards. Fiscal neutrality over the medium-term, equivalent treatment of euro area and non-euro area member states, and no costs for non-participating member states are three important principles of the common backstop, all fully enshrined in the set-up of the instrument. The repayment and recoupment capacity of the SRF is a key parameter of the common backstop, ensuring that it will be fiscally neutral by relying on bank contributions and levies.¹⁵ Similarly, conditionality remains an underlying principle of the ESM Treaty and all ESM instruments, but the exact terms must be adapted to each instrument.

The Eurogroup in inclusive format agreed in principle to set €68 billion as the maximum amount (the nominal cap) for the revolving credit line underlying the common backstop. In order to 'protect' the ESM's overall lending capacity, the existing ESM instrument for the direct recapitalisation of financial institutions (DRI) will be cancelled upon establishment of the common backstop. The DRI, set up at the end of 2014,¹⁶ was designed to break the vicious link (or, as some say, "doom loop") between the sovereign and the banking sector by allowing the

¹¹ SRB press release dated 17 July 2019, available at <https://srb.europa.eu/en/node/804>.

¹² The initial technical details are enshrined in the terms of reference of the common backstop to the SRF as agreed by the Eurogroup of 4 December 2018, available at https://www.consilium.europa.eu/media/37268/tor-backstop_041218_final_clean.pdf.

¹³ The SRB is the borrower under the backstop facility.

¹⁴ Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014, establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund.

¹⁵ As set out in more detail in 'Can the ESM as a common backstop to the SRF weaken the sovereign-bank link' by Léa Caillouet, Matjaž Sušec and Beatriz Urquiza in *Bancni vestnik*, the journal for money and banking, volume 67, no 11, November 2018.

¹⁶ The ESM Board of Governors approved the instrument on 8 December 2014. It appears that December is often a decisive month for ESM purposes.

ESM to lend directly to banks in financial difficulties. To this end, the ESM had reserved an amount of €60 billion. The DRI was never used, and with the entering into force of the SRMR and the Bank Recovery and Resolution Directive, it was not very likely to be used.

From a financial risk point of view, the ESM's position is better served under the backstop than it was under the DRI. That is because, if used, the DRI would have brought exposure to the individual banks receiving the recapitalisation, whereas exposure under the backstop facility is to the SFR (and the banking sector as a whole). Due to this difference in the credit exposure, the backstop facility will, if used, consume the ESM available lending capacity of €500 billion only in the amount actually used, whereas activating DRI while keeping the ESM's credit quality would have consumed a multiple of that capacity. To be effective, the ESM needs both a significant lending capacity and a high credit quality, the latter ensuring the low cost-of-funding which the ESM passes on to beneficiaries of financial assistance. In this light, the replacement of DRI with the backstop is a positive development both for the ESM and for the beneficiaries of financial assistance.¹⁷

Disbursements under the backstop will be subject to approval by the ESM Board of Directors on a case-by-case basis, with national parliamentary involvement where required. In a bank resolution, time is usually of the essence. Experience has shown that these actions tend to be taken 'over-the-weekend' to contain market turmoil and avoid a bank run. Therefore, the procedure of the ESM Board of Directors when deciding whether to activate the common backstop foresees a decision in principle within 12 hours following the request for funds by the SRB. In exceptional cases, especially in cases of particularly complex resolutions, the ESM Managing Director may extend the deadline by 12 hours, resulting in a maximum total of 24 hours. To a certain extent, this mimics the 'over-the-weekend' resolution operation, and ties in with decision-making in the context of the SRMR.

Despite this expedited process, national procedures must still be respected and they thus led to modifications in the usual decision-making process of the ESM Board of Directors. These modifications effectively split the process in two: a first conditional decision, based only on a draft resolution scheme prepared by the SRB and subject to the fulfilment of further conditions; and a later confirmation of that decision if there were no material changes to the information initially provided to the ESM.

In order for the decision-making process to be effective, the ESM's governing bodies need to receive the relevant information while still respecting its confidential nature. The provision of funds by the ESM is subject, among other things, to the SRB having sufficient repayment and recoupment capacity to ensure fiscal neutrality, as assessed by the ESM. The ESM Board of Directors may ask for more information from the SRB, if needed. The loans under the backstop will, in principle, have a maturity of three years, extendable for a maximum of two years should the ESM Board of Directors so decide.

In contrast to the current ESM instruments, by providing the common backstop to the SRF the ESM will financially support an EU entity, not a sovereign.¹⁸ This difference in scope is reflected in Article 3 of the revised ESM Treaty, where the granting of backstop financing was explicitly added to the purpose of the ESM.

In parallel with the inclusion of the common backstop in the ESM Treaty, the euro area member states agreed on a new draft guideline for the backstop facility. This guideline sets out in more detail the specifics of the common backstop. The ESM Pricing Policy will be updated as well, to

¹⁷ See, for example, Fitch's press release "Proposed Reform Could Boost ESM's Intrinsic Risk Profile", available at <https://www.fitchratings.com/site/pr/10037062>.

¹⁸ The SRB is an EU agency.

stipulate how the costs of the backstop facility will be calculated and passed on to the SRB. At the time of writing, the backstop facility agreement between the ESM and the SRB is being finalised at the technical level, and is expected to be endorsed later on by the governing bodies of both institutions.

Other ESM internal documents will need to be updated before the entry into force of the common backstop. This is expected to occur by the end of the transition period, unless an early introduction of the backstop is agreed following sufficient risk reduction measures within the EU banking sector. The relevant institutions and competent authorities are expected to assess this aspect in June 2020, covering also the minimum requirement for the build-up in own funds and eligible liabilities (MREL) and the trend in the reduction of non-performing loans.

The establishment of the common backstop to the SRF reinforces and complements the second pillar of Banking Union. It follows lengthy political discussions, where it was packaged with other topics related to the enhancement of the Economic and Monetary Union. It involved a discussion on controversial elements, including opening the ESM Treaty to allow the ESM to provide financial support to an EU agency. As did other changes to the ESM Treaty, it required balancing between the current ESM legal framework and the EU legal order, in particular the framework for bank resolutions. That the parties have been able to reconcile these aspects and deal with diverging views between euro area member states, building the backstop into a credible and operational financial instrument in a limited time period, whilst also giving up DRI, seems to be an appropriate end result.



3. Precautionary instrument

The changes to the precautionary financial assistance instrument aim to make it more attractive. Some of those interviewed for the 2017 EFSF/ESM Financial Assistance Evaluation Report suggested that precautionary instruments have not yet been used in part due to a perceived lack of clarity as to the conditionality that could be attached to this form of assistance.¹⁹ The other reason to update this instrument is the protection of the so-called ‘innocent bystander’; a country which is generally economically sound but subject to an ad hoc shock outside of its control.

Article 14 of the revised ESM Treaty, together with new Annex III, addresses these issues by detailing the eligibility criteria and the conditionality to be met. As of today, precautionary financial assistance can be granted via a Precautionary Conditioned Credit Line (PCCL) or via an Enhanced Conditions Credit Line (ECCL). The ESM Treaty revision focused mainly on the PCCL.

Access to a PCCL will be based on a set of pre-agreed eligibility criteria and limited to euro area member states whose economic and financial situation is fundamentally strong and whose government debt is sustainable. As a rule, to access a PCCL euro area member states will need to meet quantitative benchmarks and comply with qualitative conditions related to EU surveillance. The eligibility criteria include a two-year track record preceding the request for a PCCL of a general government deficit not exceeding 3% of GDP, a general government structural budget balance at or above the country-specific minimum benchmark, and a debt/GDP ratio below 60% or a reduction in the differential with respect to 60% over the previous two years at an average rate of 1/20 per year. In addition, the requesting country must have access to international capital markets on reasonable terms and a sustainable external position. It must also not be experiencing excessive imbalances or severe financial sector vulnerabilities.

The revised quantitative and qualitative eligibility criteria for PCCL have been criticised as stricter than would be desirable – in fact, stricter than even the current PCCL terms.²⁰ We agree that this may be the case. Yet the criteria relate to those used for excessive deficit surveillance under the Stability and Growth Pact (SGP),²¹ essentially to measure the soundness of the financial situation of member states. The purpose of ESM PCCL is to support euro area member states that are, in essence, economically sound.²² It seems logical to align the criteria for accessing an instrument that aims to be available only to countries with a sound economic situation with the pre-existing standard used to assess a country’s economic soundness. In that sense, we tend to regard criticism of the PCCL eligibility criteria as a proxy either for criticism of the SGP criteria as a measure of economic soundness, criticism of the principle that PCCL should only be accessible to countries with sound economic conditions, or both. At the same time, we acknowledge that some of the PCCL eligibility benchmarks are not fully aligned with the corresponding part of the SGP framework. This was the outcome of the political discussion on ESM reform.

Access to a PCCL will no longer entail a Memorandum of Understanding between the requesting Member and the ESM. Instead, the requesting Member will sign a Letter of Intent committing it to continue to comply with all eligibility criteria. This move from a bilateral to a unilateral

¹⁹ EFSF/ESM Financial Assistance Evaluation Report (2017), p.60, available at <https://www.esm.europa.eu/financial-assistance/evaluation-efsfesm-programmes>.

²⁰ For more detail, see Claeys, G., and Collin, M., “Does the Eurogroup’s reform of the ESM toolkit represent real progress?” (2018), available at <https://bruegel.org/2018/12/does-the-eurogroups-reform-of-the-esm-toolkit-represent-real-progress/>.

²¹ For the quantitative criteria, Protocol (no. 12) on the excessive deficit procedure establishes both the 3% deficit and the 60% debt-to-GDP rule. Article 2(1)(a) of Council Regulation (EC) No 1467/97, on speeding up and clarifying the implementation of the excessive deficit procedure, sets the 1/20 reduction as sufficient to establish that an excessive debt-to-GDP ratio is being reduced at a satisfactory pace.

²² This is true both before and after this reform. For the pre-reform situation, please see the ESM Guideline on Precautionary Financial Assistance, available at https://www.esm.europa.eu/sites/default/files/esm_guideline_on_precautionary_financial_assistance.pdf.

instrument increases domestic ownership of the measures needed to ensure continuing compliance with the eligibility criteria. It may also help with the political stigma connected to a request for a programme, and with the acceptance of conditionality that is often regarded in the national debate as a foreign imposition.²³ Continuous respect of the eligibility criteria will be assessed at least every six months.

²³ This stigma has been mentioned as a reason for some euro area countries requesting support later than they probably should have. See EFSF/ESM Financial Assistance Evaluation Report, p. 29 (including references to IMF programmes and sources quoted in the footnote).

4. Broader role in and outside of programmes

In addition to the further development of some of the ESM's financial instruments, the role and position of the ESM itself in the crisis prevention and resolution framework is envisaged to be broadened as well. Among other elements, the updated ESM Treaty provides for a larger role in the preparation and monitoring of euro area countries support programmes (including the verification of conditionality), and a more enhanced role in the assessments of the debt sustainability and the repayment capacity of euro area member states.

As mentioned in the introduction, the role of the ESM has grown over time. Initially, its main task (inherited from the EFSF) was to raise and disburse the money necessary for the rescue loans by issuing bills and bonds in the financial markets. Especially with the ESM programmes for Cyprus and Greece, the ESM became increasingly involved in financial and policy-related issues and has worked closely in particular with the European Commission, but also with the European Central Bank (ECB), and the IMF. The ESM also developed its own institutional views on debt-related issues, including debt sustainability matters as well as the repayment capacity of the programme countries. The euro area member states wanted to reflect this increased involvement in the updated ESM Treaty. As such, several items are currently introduced in the draft treaty text.

When a euro area member state requests financial assistance, the ESM, the European Commission, and the ECB will work closely together to prepare the assessments supporting the decision to grant a loan. These include the assessment of a Member's debt sustainability and repayment capacity, the assessment of financial stability risks, and the financing needs of the country requesting support. The ESM will perform its analysis and assessment from the perspective of a lender.²⁴

The assessment of debt sustainability and repayment capacity for a euro area member state requesting financial assistance will be carried out on a transparent and predictable basis. To this end, the ESM and the Commission agreed the principles for conducting the debt sustainability assessment (DSA) and the repayment capacity assessment (RCA) in a staff working paper. For the preparation of the DSA, the Commission will analyse the growth forecasts and estimates, existing stocks and stock-flow adjustments, net borrowings and fiscal path, incorporating its in-house assessment of compliance with SGP requirements. By leveraging the unique capital market knowledge of the ESM financial teams, the ESM will contribute to the DSA with the analysis of the country's financing plans and cost of funding. This includes the assessment of the country's liquidity position, sovereign bond market and potential risks stemming from the size and structure of outstanding debt, debt issuance plans, interest rate developments, refinancing capacity and market access. The repayment capacity assessment builds upon, and complements, the DSA and shifts the focus to the beneficiary euro area member state's ability to manage its overall payment obligations, or liabilities, in a way that ensures the repayment to the ESM over the entire horizon of the lending relationship.

Furthermore, the ESM will be involved in the design of policy conditionality and any future Memorandum of Understanding (MoU) detailing such conditionality attached to the financial assistance facility that will be signed by the Commission and by the ESM Managing Director. Currently, the Commission signs the MoU as an agent on behalf of the ESM.²⁵ The ESM will also monitor compliance with the conditionality attached to the financial assistance facility together

²⁴ Article 13(1) of the amended draft ESM Treaty.

²⁵ See Article 13(4) of the current ESM Treaty. The General Court of the European Union clarified in *Ledra v. Commission and ECB* (T-289/13; ECLI:EU:T:2014:981) that, while the MoU does not originate with the Commission (paragraph 46), the Commission is still under an obligation to ensure that the MoU is in line with EU Law, and the Union may incur non-contractual liability if the Commission fails to do so (paragraph 49).

with the Commission and the ECB.²⁶

The ESM continues to participate in post-programme monitoring to safeguard its balance sheet by assessing the ability of a beneficiary Member to repay. The Early Warning System Procedure established pursuant to Article 13(6) of the current ESM Treaty starts with the first disbursement and continues until all financial assistance is fully repaid. In principle, post-programme surveillance missions by the Commission and early warning system missions by the ESM are to be combined to prevent unnecessary duplication of analysis by the two and to avoid placing an unnecessary burden on the relevant country. In addition, and as already possible, the Treaty emphasises that the ESM is capable of following and assessing all its Members (also outside of programmes) so that it can execute its tasks as a crisis resolution authority for the euro area appropriately and in a timely manner.²⁷ During the discussions on these topics, the need to find a balance between the requirements of EU Law and these new tasks for the ESM also became clear. Therefore, despite the ESM remaining a legal instrument of public international law, the amended ESM Treaty has various references to EU law and specific competences for the relevant EU institutions.

The European Commission and the ESM will, both in- and outside of programmes, meet informally to share assessments and analysis pertaining to their respective competences as well as to discuss and assess macro-financial risks. The Commission, in agreement with the Member State concerned, may also invite ESM staff to join its missions related to economic policy coordination and budgetary monitoring under EU law.

The current cooperation with the Commission is reflected in a joint memorandum of understanding signed in April 2018.²⁸ In November 2018, the Commission and the ESM agreed on a further “joint position”.²⁹ The joint position on future cooperation is incorporated in a Memorandum of Cooperation (MoC), which will enter into force at the same time as the amendments to the ESM Treaty.³⁰ This MoC outlines the basis for the two institutions to work together going forward. This is not the ESM’s only tie to the EU body politic: there is also a history of dialogue with the European Parliament, to whom the ESM Managing Director presents, on a voluntary basis, important developments on ESM activities.³¹

²⁶ Articles 13(3), (4) and (7) of the amended draft ESM Treaty.

²⁷ Article 3(1) of the amended draft ESM Treaty. We note that the ESM is already entitled to conduct these tasks under the ‘implied powers’ doctrine under public international law. The euro area member states, however, showed willingness to make this more explicit in the updated ESM Treaty.

²⁸ Memorandum of Understanding on the working relations between the European Commission and the European Stability Mechanism between the ESM and the European Commission, 27 April 2018, available at <https://www.esm.europa.eu/content/memorandum-understanding-working-relations-between-european-commission-and-european>.

²⁹ “Joint position on future cooperation between the European Commission and the ESM” (19 November 2018), point no. 8, available at <https://www.esm.europa.eu/press-releases/joint-position-future-cooperation-between-european-commission-and-esm>.

³⁰ Article 13(8) and Recital 5B of the amended draft ESM Treaty. This Memorandum of Cooperation between the ESM and the European Commission was agreed at technical level between the two institutions and endorsed by the ESM Board of Directors at the end of 2019. Once agreed by the relevant governing bodies of the Commission, it is expected to be published.

³¹ The ESM Managing Director often appears before the Economic and Monetary Affairs Committee (ECON) of the European Parliament, when invited to do so by the Committee.



5. Debt sustainability issues and CACs

From its inception, euro area member states have meant for the ESM to provide financing only when the loan recipient's debt was deemed sustainable. Article 13(1)(b) of the current ESM Treaty requires a debt sustainability analysis to be carried out prior to the ESM Board of Governors approving in principle a request for assistance. This analysis was meant "wherever appropriate and possible, (...) to be conducted together with the IMF", as a euro area member state requesting ESM financial assistance was also expected to make a similar request to the IMF.³² This expectation of IMF involvement³³ opened the door for IMF lending principles (including on not lending into unsustainable debt situations)³⁴ to be absorbed into ESM lending.

However, this does not mean that political decision-making was out of the picture. Mutual agreement at ESM Board of Governors level – which in many countries requires parliamentary involvement – was the ultimate factor, regardless of the circumstances. This is because the euro area member states are the owners of the ESM and its capital, and need to have the flexibility as well as the ultimate discretion to decide each situation at the right time under the precise circumstances, looking at both the context and the constraints at that time.

Against this background, the Term Sheet on ESM Reform needed only to "reaffirm the principle that financial assistance should only be granted to countries whose debt is sustainable and whose repayment capacity is confirmed".³⁵ Yet with the reference to requesting IMF assistance in Recital (8) of the ESM Treaty changing from "whenever possible" to "whenever appropriate" (suggesting a desire for a more "insourced" response to financial stability issues in euro area member states going forward), euro area member states agreed to further stipulate this sustainability requirement.

The amended draft ESM Treaty states, in a new recital, the general principle that the ESM should only provide financial assistance to euro area member states "whose debt is considered sustainable and whose repayment capacity to the ESM is confirmed".³⁶ While this is not repeated in the operative provisions of the updated treaty text (as it was absent from the current one), Article 13, which outlines the procedure for granting ESM financial assistance, retains the requirement in the current ESM Treaty to "assess whether public debt [of the requesting a euro area member state] is sustainable". As mentioned in the previous section, Article 13(1)(b) adds detail on how this assessment is carried out, notably that it shall:

- focus not only on the general sustainability of the country's debt but also, specifically, on whether ESM financial assistance can be repaid; and
- be conducted "in a transparent and predictable manner while allowing for sufficient margin of judgement".³⁷

While providing a blueprint for the institutions in charge of carrying out the debt sustainability assessment, the amendments to the ESM Treaty in this regard do not alter the nature of the decision to grant (or not to grant) financial assistance to a requesting euro area member state.

³² Recital 8 of the amended draft ESM Treaty.

³³ The IMF had been involved in all three EFSF programmes (Ireland, Portugal, and the EFSF 2012 Greek programme), prior to the creation of the ESM. It was then involved in the ESM programme for Cyprus and, though not providing financing under the ESM 2015 programme for Greece, remained a stakeholder through its involvement in the 2012 programme and provided technical assistance. The only situation where the ESM provided any kind of financing without IMF involvement was the facility granted to Spain in 2012/2013 for the indirect recapitalisation of the Spanish banking system, where the nature of the facility (and the purpose of the funds granted) led to the IMF not being involved.

³⁴ See, for example, the IMF's Exceptional Access Policy and its well-known "sustainable with a high degree of probability" criterion.

³⁵ Term Sheet on the European Stability Mechanism reform, 4 December 2018, p. 3 (underlined by the authors).

³⁶ Recital 11(b) of the amended draft ESM Treaty.

³⁷ For a description of the process leading to the production of this analysis, see the section on "broader role in and outside of programmes".

It is still a political decision, which needs to be accepted by all euro area member states at cabinet level and, where national law so requires, by national parliaments.

The description above makes clear that some often-heard claims about this aspect of ESM reform are, in fact, unsubstantiated. On the one hand, national governments retain veto powers in deciding whether the ESM will or will not grant financial assistance following a request from one of its Members. On the other hand, there is no loss of flexibility for political decision-makers, as there is no situation where the ESM Treaty forbids the ESM Board of Governors from approving a request for an ESM programme if all euro area member states are willing to accept it.^{38 39}

Even if one were to equate Recital 11(b) with a requirement that financial assistance can only be approved on the back of a favourable Article 13(1)(b) debt sustainability analysis,⁴⁰ this provision still requires the debt sustainability analysis to allow for “sufficient margin of judgement”. Naturally, this is not a license to compromise the integrity of the technical work underlying the analysis. In fact, an operative provision has been included in the draft amended ESM Treaty to emphasise that ESM staff are independent in the performance of their duties.⁴¹ Yet where the outcome of the analysis is contingent on assumptions as to how certain quantitative and qualitative indicators will behave, the analysis should indicate that clearly and provide for outcomes under different scenarios. This will inevitably broaden the scope of possible conclusions that might be drawn from the analysis, possibly to the point of legitimising opposing positions from different euro area member states on the same proposal.

Another point often misunderstood in the discussion around the debt sustainability angle of the ESM Treaty reform is the role of CACs. CACs have been part of the architecture of euro area sovereign debt since 2013 (and even earlier, with respect to euro area sovereign debt issued under foreign law), and are no more than common language agreed between the euro area member states, which forms part of the terms of every bond with over one-year maturity issued by euro area member states. That language determines how a euro area member state can put amendments to the terms of its sovereign bonds to a vote by the investors holding those bonds.

The reform of the euro area model CAC, which is part of the agreed ESM reform,⁴² essentially consists of replacing the current “double-limb” voting structure with a “single-limb” voting structure. This follows an international trend, as more and more sovereign issuers have been adopting the single-limb model CAC since its endorsement by the IMF in October 2014.⁴³

³⁸This point is worth stressing as even those who are well versed on ESM topics can misunderstand it. For example, Messori, M. “The flexibility game is not worth the new ESM” (2019), p. 7: “[the amended ESM Treaty] states that ESM interventions in support of a member state are bound by the sustainability of its public debt”.

³⁹ The situation is different for the PCCL, as described in the section on “precautionary instrument”, which is subject to ex ante eligibility criteria – including debt sustainability – that apply even if all euro area member states wished they did not. This is explained by the nature and scope of that instrument, as well as the simplified conditionality foreseen in Article 14(3) of the amended draft ESM Treaty.

⁴⁰ This would require both awarding operative nature to Recital 11(b) *and* concluding that the debt sustainability analysis under Article 13(1)(b) is binding on the Board of Governors in determining whether debt is sustainable. Each of these interpretations strikes the authors as being at least questionable.

⁴¹ Article 7(4) of the amended draft ESM Treaty.

⁴² The source of the commitment by euro area member states to adopt the existing double-limb CAC is Article 12(3) of the current ESM Treaty, which is being amended to reflect the adoption of single-limb for bonds issued from 2022. The single-limb CAC itself was prepared in parallel with the negotiation of the ESM Treaty by the debt management offices of all euro area member states. The final draft was agreed by all debt management offices and submitted to a market consultation involving more than 250 stakeholders, before becoming part of the political decision-making processes.

⁴³ According to the IMF, the single-limb CAC was included in approximately 88% of international sovereign bonds issued between October 2014 and October 2018. IMF, “Fourth progress report on inclusion of enhanced contractual provisions in international sovereign bond contracts” (2019), p. 4.

The difference is that double-limb requires amendments to be approved both by a majority of bonds within each individual bond issuance affected by the issuer's proposal and by a majority of all bonds of all issuances in the aggregate, whereas single-limb requires only the latter. This means that the power to reject a restructuring proposal for new bonds issued after 2022 will be with the community of affected bondholders as a whole, while the holders of each individual issuance will no longer have an inherent veto over the restructuring of that issuance. This, in short, is what is called a single-limb CAC.

While every euro area member state committed to making the common language part of its bond terms,⁴⁴ they did not necessarily commit to using it ahead of applying for, or receiving, any form of support from the ESM. The debt sustainability principle underlying ESM financial assistance does not require, in theory or in practice, that a country restructures its public debt as a pre-condition for receiving financial assistance. For example, in a majority of IMF-supported programmes, the policy conditionality attached to the programme and the catalytic effect of IMF support on investment from other sources was enough to allow the countries in question to return to medium-term sustainability, repay the IMF, and continue to service their remaining public debt according to its original terms.⁴⁵

In spite of the above, it has been suggested⁴⁶ that, by ending the veto at the level of each issuance and thereby possibly facilitating the approval of restructuring proposals, the reform of the CAC increases the likelihood that a euro area member state will restructure its debt. As the argument goes, at the first sign of trouble in a euro area member state, markets would regard the existence of single-limb CACs in that country's bonds as a sure sign that debt restructuring would be imposed as a pre-condition for official sector support. This would then become a self-fulfilling prophecy as investors hurried to sell their bonds. The implicit counter-factual is that if the CAC were to remain "double-limb", the added difficulty of approving a restructuring proposal would discourage countries from adopting this path, thereby reducing the risk of loss for investors.

It is difficult to debate this matter based on expectations of market behaviour, as no one can know for sure if markets will behave in line with those expectations. However, we can evaluate if this alleged market perception (i.e., that a country is more likely to end up paying its investors in full if its bonds contain double-limb rather than single-limb CACs) fits what we have seen in the euro area so far, and what the current environment suggests we might see going forward. On that basis, we believe that perception to be unjustified.

As explained in the previous section, the institutional response to public debt distress in a euro area member state starts with a request for support by that member state, followed by a debt sustainability analysis done by the institutions, leading to a decision by other euro area member states to approve, or not to approve, financial assistance. The final decision to propose (or not) a restructuring to bondholders is taken by the distressed member state before the other member states decide on the request for financial assistance. With this sequence in mind, a distressed member state has an incentive to consider debt restructuring when needed to persuade other member states to approve the request for financial assistance. This persuasion tool becomes more relevant the more the analysis by the institutions points to the unsustainability of the country's debt in the absence of restructuring.

Foregoing the introduction of single-limb CACs may well create a situation where a voluntary

⁴⁴ Article 12(3) of the current ESM Treaty.

⁴⁵ International Monetary Fund, "Sovereign Debt Restructuring – Recent Developments and Implications for the Fund's Legal and Policy Framework" (2013), p. 7.

⁴⁶ For example, see Minenna, M., "The European (In)Stability Mechanism" (2019), available at <https://ftalphaville.ft.com/2019/12/16/1576516020000/The-European--In-stability-Mechanism/>.

restructuring is both unfeasible (because there are not enough votes to restructure all series under double-limb) and perceived by the market as such. To regard this as a preferable outcome implies a belief that fellow member states will always choose to bail out private investors in full using ESM money over having a euro area member state default (or exit the euro area and redenominate its bonds). It also implies the separate belief that markets always anticipate that choice and remain calm, regardless of their own views on the medium-to-long-term sustainability of the country's debt. While these may seem acceptable assumptions in some cases, it seems rather bold to base the structure of crisis resolution for the entire euro area on them holding true every time, all the time. There are simply too many variables in play in the ever-shifting political landscape of the euro area.

Admittedly, the situation is not always this black and white. Debt sustainability analyses can produce different scenarios to support more than one conclusion, making the case for debt restructuring arguable on both sides. In those cases, having single-limb instead of double-limb CACs can be an argument in favour of the practicability of restructuring, and help create the self-fulfilling prophecy feared by the opponents of CAC reform. Yet one needs to weigh this against the possibility that, even though the debt of the distressed member state is arguably sustainable, at least one other member state is simply not in a position to sanction the use of official sector funds without some level of debt restructuring. Double-limb would then be sub-optimal to single-limb in two ways. First, it would make a moderate voluntary restructuring more difficult to approve; second, it would provide no way to deal with individual bond issuances where holdout investors acquire blocking minorities. In the interest of a successful restructuring, the distressed country might need to exempt those issuances from the restructuring, increasing the burden placed on other investors and creating a perception of relative injustice.⁴⁷ The deterioration in the relationship with investors could then undermine the distressed country's plans to return to the markets eventually.

A new recital in the ESM Treaty clarifies that a euro area member state may call upon the ESM to facilitate the dialogue with investors, if the national authorities of that member state find it helpful.⁴⁸ The recital risks being read as portraying a more interventionist role than it means to. In fact, it is mostly about making explicit something that was already implied: if a euro area member state asks for assistance in organising discussions with its creditors, the ESM will assist. Any such assistance will be informal, non-binding (assuming the country in question asks for advice, which they are also free not to do), temporary, and confidential.

Overall, we are of the view that the envisaged ESM reform produces a middle-of-the-road solution for debt sustainability issues. On the one hand, it leaves substantial policy-making space for ESM governing bodies and national political actors, by steering clear of any automatic, "one-size-fits-all" approach to distressed debt scenarios. We believe that this is as it should be, given the variety of circumstances that our currency union can generate. On the other hand, it equips those actors with a tool, in the form of the single-limb CAC, to help deliver the different burden-sharing balances negotiated between creditors, debtors, and official sector stakeholders with less legal risk than unilateral action.

⁴⁷ This may help explain why economic studies often find that introducing CACs in sovereign bonds may lead to better pricing for the sovereign issuer. That discussion is outside the scope of this paper but we can mention, for example, the work of Picarelli, M., Erce, A., and Jiang, X. in "The Benefits of Reducing Hold-Out Risk: Evidence from the Euro CAC Experiment, 2013-2018", (2019) *Capital Markets Law Journal*, Volume 14, Issue 2, pp. 155–177, April 2019. Also available as ESM Working Paper Series, no. 33.

⁴⁸ Draft Recital 11(a) of the amended ESM Treaty.

6. Conclusion

The ESM reform is the outcome of seven years of successful financial assistance operations by the ESM as the lender of last resort to the countries of the euro area. During this period, the ESM evolved from a mere funding-to-lend mechanism to a full-blown crisis prevention and resolution mechanism. Much of the current ESM Treaty reform is about crystallising this evolution, recognising the increasingly prominent role of the ESM during this period.

The agreement between the euro area member states on the reform of the Economic and Monetary Union has been characterised by some as not ambitious enough. We understand why, but take a more favourable view on what the euro area has achieved, especially in the context in which it did so. Even without an immediate threat of a crisis (like the one that led to the creation of the EFSF in 2010), and in a period where the currency union is under deep political discussion in some member states, EU countries (euro area and non-euro area) still came together and agreed in principle on a significant degree of incremental improvements to the ESM as a crisis resolution mechanism.

The role of backstop to the SRF will effectively replace the existing – but never used – DRI instrument. We believe that the euro area will gain from the switch. Even with its rather inflexible decision-making, the backstop is still more usable, in practice, than the DRI instrument ever was. The introduction of the backstop will strengthen the SRF's ability to respond in resolution, thus strengthening Banking Union and, we hope, helping to break the vicious loop between sovereigns and their domestic banks. It is also a better solution from the point of view of the ESM's lending capacity and credit quality.

The increase in the efficiency of precautionary instruments is one point where one might reasonably say that the euro area fell somewhat short of its initial aspiration. It may have been the victim of the broader political debate regarding the SGP criteria. We too wonder whether these instruments have been made substantially more efficient and attractive compared to their initial set-up. Only time will tell.

Despite the many changes, the overall governance and decision-making framework of the ESM remains broadly the same. This posed quite a challenge when designing and agreeing on many of the reform items, especially in the case of the common backstop to the SRF.

Finally, we also see progress on debt sustainability matters. The euro area member states have struck a sensible balance between the need for strong technical input on debt sustainability ahead of a decision to grant ESM financial assistance and the principle that the decision itself should, in the end, remain in the political sphere. The ESM will play a larger role in the technical assessment, drawing in particular on its expertise as a lender, leveraging on the capabilities and responsibilities it developed during the financial assistance programmes. At the same time, the European Commission retains the competences that the EU Treaties bestow on it. The introduction of single-limb CACs in euro area bonds as of 2022 provides a mechanism for orderly renegotiation of unsustainable sovereign debt, if (and only if) needed. Criticism of their introduction on the basis that it amounts to a larger degree of automatism in handling distressed debt scenarios is, in light of the wider context, misguided.

Acronyms

CAC	Collective action clause
DRI	Direct Recapitalisation Instrument
DSA	Debt sustainability analysis
ECB	European Central Bank
ECCL	Enhanced Conditions Credit Line
EFSF	European Financial Stability Facility
ESM	European Stability Mechanism
EU	European Union
GDP	Gross domestic product
IMF	International Monetary Fund
MoC	Memorandum of Cooperation
MoU	Memorandum of Understanding
PCCL	Precautionary Conditioned Credit Line
RCA	Repayment capacity assessment
SGP	Stability and Growth Pact
SRB	Single Resolution Board
SRMR	Single Resolution Mechanism Regulation
SRF	Single Resolution Fund