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European Stability Mechanism

2015
ANNUAL REPORT

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INTRODUCTION TO THE ESM

The European Stability Mechanism (ESM) is a crisis resolution mechanism established by the euro area countries. The ESM's mission is to provide financial assistance to ESM Members experiencing or threatened by severe financing problems to safeguard the financial stability of the euro area as a whole and of its Members.

The Luxembourg-based ESM raises funds by issuing debt instruments, which are purchased by institutional investors. The proceeds enable the intergovernmental institution, in operation since 8 October 2012, to provide its Member States the following types of financial assistance:

- loans to cover their financing needs;
- loans and direct equity injections to recapitalise financial institutions;
- credit lines to be used as precautionary financial assistance;
- primary and secondary debt market purchases of Member States' national bonds.

ESM financial assistance is linked to beneficiary Member States addressing weaknesses in their economies through reforms which are jointly agreed by that Member, the European Commission, in liaison with the European Central Bank and, where applicable, the International Monetary Fund.

More information about the ESM can be found on our website:
www.esm.europa.eu.

Note: The ESM 2015 Annual Report contains the audited Financial Statements as at 31 December 2015, together with the report of the external auditor in respect of their audit concerning these Financial Statements, and the report of the Board of Auditors in respect of these Financial Statements. The description of ESM policies and activities covers the 2015 financial year, except when stated otherwise. The economic report (Chapter I) includes certain information available up to 21 April 2016, but all historic financial data there set out is limited to the period to 1 April 2016.

MESSAGE FROM THE MANAGING DIRECTOR

Klaus Regling

Managing Director
European Stability Mechanism

The year 2015 was a difficult but also successful one for the European Stability Mechanism (ESM). Greece was the chief challenge. While Cyprus emerged strengthened from its ESM loan programme in March 2016, and the other former ESM or European Financial Stability Facility (EFSF) programme countries shone as economic bright spots, Greece remained an exception.

At the start of 2015, Greece's second programme was ongoing, following an extension at the end of 2014. In January 2015, a new government was elected with a mandate to search for an alternative way to deal with Greece's financial problems. This effort collapsed in June with the expiration of the second programme without a final disbursement or an immediate follow-up programme.

This ultimately fruitless pursuit of other options in the first half of 2015 resulted in a severe setback for the Greek economy, culminating in bank closures and capital controls and undoing much of the good achieved from earlier reforms. Reforms came to a halt during this period; some were even rolled back. For example, Greece failed to put into law the legislation needed to implement pension reform and it weakened the tax administration reforms. The underlying positive trend as regards the fiscal balance was reversed and the deficit widened again. All this would later require painful new steps. In addition, the general government arrears rose by more than 50% between December 2014 and July 2015, taking a further toll on the economy.

As the summer progressed and the Greek economic and financial situation became increasingly untenable, Prime Minister Alexis Tsipras's government made an official request for additional financial help. The euro area countries agreed that the ESM should lead a third programme for the country of up to €86 billion until mid-2018. The ESM Board of Governors approved the programme in August. The next month, the government won a new mandate from the Greek population and reforms resumed.

During the last four months of 2015, the ESM disbursed €21.4 billion to Greece out of the new programme, including €5.4 billion to cover bank recapitalisation costs. With the EFSF already Greece's largest creditor, total EFSF and ESM current outstanding loans amount to €152.3 billion. This total represents the largest overall loan amount ever made to any country. Together, the EFSF and ESM currently hold 48.9% of Greek public debt. If the third programme of up to €86 billion is fully disbursed that total figure will rise further, though I do not at present expect the full amount to be needed, unless circumstances change radically.

We at the ESM know that there are real people behind all these numbers; people who have made, and continue to make, sacrifices. Tackling reforms is tough: curtailing pension rights, for example, upends life-long plans for retirement. For the Greek people, as well as those of other programme countries, it is always painful to have wages, pensions, or other benefits cut – even though such cuts are typically needed to correct excessive increases in previous years or decades. In many cases, people have renounced a great deal to help restore their economies to sustainable working order. However, these measures will pay off in the longer term by supporting future growth.

In all its programmes, the ESM seeks to ease the repayment burden for its programme countries. It passes on its low funding cost and provides other implicit savings by, for example, pushing repayments much further down the road than other international financial institutions, such as the IMF. The beneficial terms offered to Greece in 2012, for example, are equivalent to a reduction of 40% of Greek public debt held by its European partners (in 2015 figures) in what economists call net present value terms, a calculation that translates future financial streams into today's money. While not a nominal haircut for creditors, and without any direct cost for European taxpayers, it represents important savings for Greece.

In 2016, the euro area achieved an important success in Cyprus, the fourth country to stage a successful programme exit following Ireland, Spain, and Portugal. The country ended its three-year programme in March, restoring economic growth and repairing public finances much faster than expected. Cyprus restructured and down-sized its financial sector, the main source of the crisis. As a result, Cyprus returned to growth in 2015 after three years of recession. Unemployment has been gradually declining since 2015. Of the total loan package of up to €10 billion, the ESM disbursed €6.3 billion and the IMF €1 billion. Cyprus did not need the remaining €2.7 billion.

Cyprus also receives favourable loan terms from the ESM. The country will begin its amortisation payments in 2025 and finish them in 2031. As with the other former programme countries, the ESM will continue to cooperate with Cypriot authorities under the ESM's Early Warning System, designed to ensure that borrowing countries are able to honour their debts in a timely fashion.

The other former EFSF/ESM programme countries continued to perform well – testimony to the effectiveness of the rescue funds' cash-for-reforms approach. Growth in Ireland and Spain outpaced the rest of Europe in 2015. Spain even stepped up the voluntary early loan repayments that it began in 2014, making two prepayments totalling €4 billion in 2015 and reducing the outstanding ESM programme amount to €35.7 billion. Greece, Ireland, Portugal, and Spain climbed into the top five of the OECD's 34 member states for implementing structural reforms.

Another favourable development last year was that Lithuania joined the ESM, a telling sign of the common currency's continued attractiveness. It made the first of five instalments on its paid-in capital, while Latvia, which joined a year earlier, contributed its second.

The ESM and EFSF together disbursed €255 billion of a joint lending capacity of €700 billion from 2011 to 2015. Taking into account what has been committed under the third Greek programme, the two rescue funds have spent or committed some €310 billion of their firepower. The remaining almost €400 billion is still unused. Although the temporary rescue fund EFSF handed over responsibility for new programmes to the permanent ESM fund in July 2013, it continues to manage its outstanding loans and to issue debt.

The EFSF and ESM fund their loans by issuing bonds and bills on financial markets. The new Greek programme required a fast, flexible response from the organisation. It meant the ESM had to raise more funding than originally planned for the year. While using short-term funding to cover the initial disbursements for the third Greek programme, the ESM also pushed its target for 2015 long-term funding higher to €23 billion from the original €14 billion.

To achieve this new goal, the ESM engaged in a very active late-year funding drive, adding 10-, 21-, 30-, and 40-year bonds to its issues. And, despite fears in some quarters that liquidity in the market was evaporating, the ESM had no trouble attracting investors to its issues. It also managed to encourage investor groups that prefer longer issues, such as insurance companies and pension funds, to boost their participation.

The financial markets also posed another challenge for ESM operations. Yields on bonds sank deeper into negative territory during 2015, making it ever more difficult to make money on capital markets. ESM Members have paid in more than €80 billion in capital, funds that underpin the ESM's high creditworthiness. The ESM is required to preserve that capital by investing it very conservatively. The ESM posted a modest profit, which it has proposed adding to its buffer against potential difficult times to come. To give our investment team more room to manoeuvre in the future, the Board of Directors agreed to expand the assets we can invest in, adding high-quality non-euro instruments and a broader universe of euro area bonds.

Given its funding activities, the ESM is in an ongoing dialogue with large investors around the world. This offers us the opportunity to tell Europe's story, as we firmly believe that Europe is in better shape than it is generally reputed to be. Europe has emerged stronger from its worst financial and economic crisis in 80 years. This is true not only on economic but also on institutional grounds.

The moderate recovery in 2015 was broad based. Several European countries worked hard to fix their home-grown weaknesses. Per capita growth in the euro area became comparable with the U.S. rate again and may exceed it in 2016 and 2017. The output gap is closing as euro area growth is above potential. The aggregate euro area budget deficit was 2% of gross domestic product in 2015, half that of the U.S. and the U.K. and a third that of Japan.

Even the European labour market has strengths that are not widely known. While the average unemployment rate is decreasing only slowly, our employment and participation rates are higher than in 2000, while in the U.S. they have dropped significantly. At the same time, income is spread across society much more equally in Europe than in the U.S. A much larger share of the population in Europe has experienced real income gains during the last 15 years than in the U.S.

In our discussions, our investors also often ask us to assess the proposals put forward by policymakers, think tanks, and academics for further euro area integration to enhance the region's resilience. These proposals comprise a wide range of subjects, including stabilisation mechanisms, financial backstops, and further institutional developments. Some refer to the ESM directly.

Empirical evidence shows that risk-sharing instruments can smooth economic fluctuations either through private sector risk sharing, via capital markets, or through fiscal instruments. The euro area lags other large countries or regions in this respect even though the EFSF and the ESM have provided significant amounts of cross-border risk sharing in recent years.

To foster further resilience, the euro area Member States must keep up the pace of reform in our economies, while the EU should complete the Banking Union and the Capital Markets Union.

During the crisis, Europe strengthened Economic and Monetary Union. Among other steps, Europe saw a wave of national structural reforms, particularly in programme countries; the European Central Bank adopted an active monetary policy, and Banking Union put the European banking system on a much stronger footing. Euro area countries, in addition to setting up firewalls with the ESM and EFSF, improved economic policy coordination. Today, the monetary union works better than before the crisis. Europeans can be justifiably proud of these accomplishments.

Yet challenges remain. As a euro area institution we believe that further measures to make monetary union more robust and crisis-proof should be carefully analysed and debated. We must all ensure that the euro area is not only better prepared for any future crisis but that it continues to thrive.

LETTER OF TRANSMITTAL TO THE BOARD OF GOVERNORS

16 June 2016

Dear Chairperson,

I have the honour of presenting to the Board of Governors the Annual Report in respect of the financial year 2015, in accordance with Article 23 (2) of the By-Laws of the European Stability Mechanism (By-Laws).

The Annual Report includes a description of the policies and activities of the European Stability Mechanism during 2015. It also contains the audited Financial Statements as at 31 December 2015, as drawn up by the Board of Directors on 18 March 2016 pursuant to Article 21 of the By-Laws, which are presented in Chapter IV. Furthermore, the report of the external auditor in respect of the Financial Statements is presented in Chapter V and the report of the Board of Auditors in respect of the Financial Statements in Chapter VI. The independent external audit was monitored and reviewed by the Board of Auditors as required by Article 24 (4) of the By-Laws.

Klaus Regling
Managing Director

01

ECONOMIC DEVELOPMENTS

PROGRAMME COUNTRIES: TRANSFORMING UNSUSTAINABLE INTO SUSTAINABLE GROWTH

EFSF/ESM programme countries entered the financial crisis already weakened.

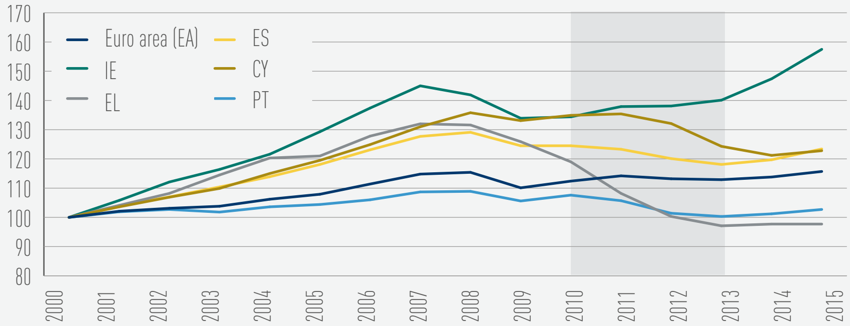
During the first decade of Economic and Monetary Union (EMU), a long period of unsustainably high growth masked deteriorating competitiveness in several euro area Member States, particularly Ireland, Greece, Spain, Cyprus, and Portugal. As a result, these countries accumulated economic imbalances. Support programmes,[1] designed to remedy such matters, required them to undertake a wide range of structural reforms, fiscal consolidation, and banking sector recapitalisation. Full and timely implementation of the support programmes put these economies back on track – with the exception of Greece. Growth prospects are now closer to a sustainable path. But the crisis has left a painful legacy of high unemployment, public debt, and non-performing loans (NPLs). To overcome these issues, programme countries should maintain strong momentum on structural reforms and institution building, while continuing with fiscal consolidation. Such policies will also help ensure sustainable growth in the future.

High growth prior to the crisis cloaked an underlying loss of competitiveness.

The launch of EMU ushered in a 10-year period of strong economic growth in the euro area periphery and income convergence in the euro area as a whole. Programme countries, namely Greece, Ireland, Portugal, Spain, and Cyprus, enjoyed a sustained period of real gross domestic product (GDP) growth (Figure 1), outpacing the euro area average. The buoyant economic activity translated into an increase in real disposable income (Figure 2). The outperformance of the periphery reduced income disparities in the euro area. These improvements, however, covered up increasing imbalances among Member States, namely a fast accumulation of external debt. The high growth led to inflation differentials. Wages grew by much more than what was justified by productivity growth. The consequent loss of competitiveness (Figure 3), exacerbated by their economies' structural rigidities, such as barriers to entrepreneurship (Figure 4), increased their vulnerability to shocks like the recent financial crisis. In the core countries, contained cost and price developments contributed to the emergence of excessive divergences of competitiveness within the euro area.

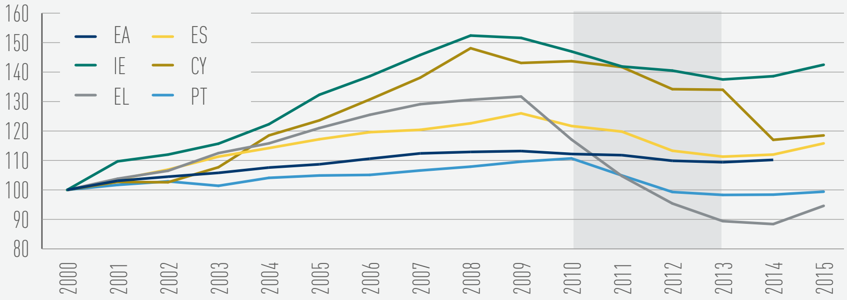
[1] Spain's programme was focused on financial sector recapitalisation, and therefore did not include explicit fiscal and structural conditionality. Instead, the Memorandum of Understanding foresees the regular monitoring of fiscal progress on exiting the Excessive Deficit Procedure and of structural reforms to correct macroeconomic imbalances identified within the framework of the European Semester.

Figure 1: Real gross domestic product
(cumulative, 2000=100)



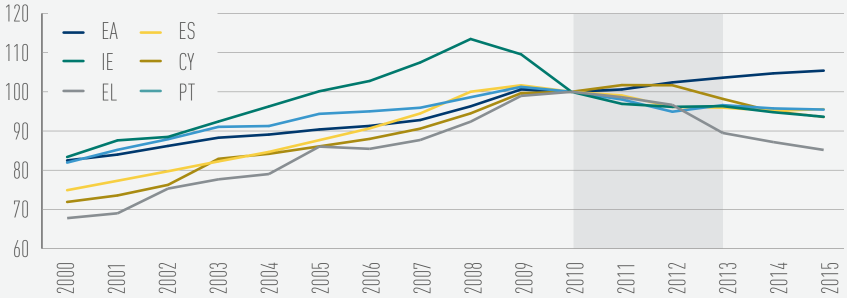
Note: The grey block represents the height of the sovereign debt crisis.
Sources: AMECO and Haver Analytics

Figure 2: Real disposable income
(cumulative changes since 2000 in %, 2000=100)



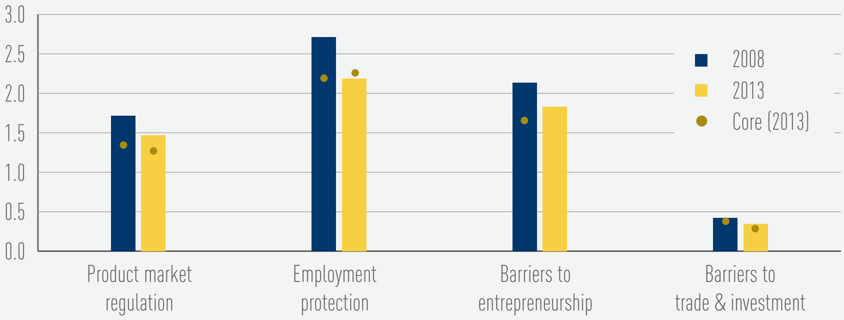
Note: The grey block represents the height of the sovereign debt crisis.
Source: AMECO

Figure 3: Nominal unit labour costs
(2010=100)



Note: The grey block represents the height of the sovereign debt crisis.
Sources: AMECO and Haver Analytics

Figure 4: Structural rigidities in the periphery

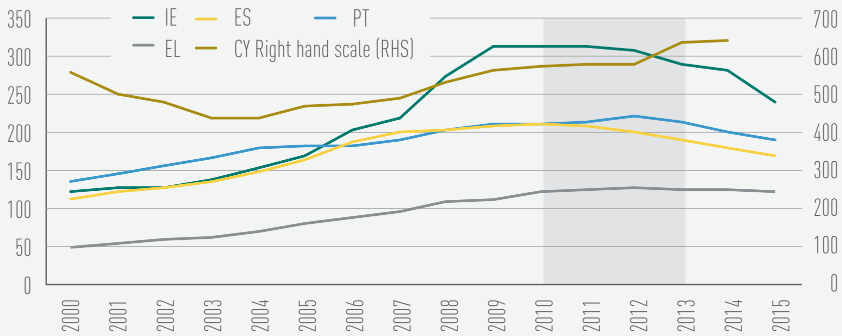


Notes: Source runs from 0 (least restrictive) to 6 (most restrictive). The core is composed of Belgium, Germany, France, the Netherlands, Austria, and Finland.
Source: OECD structural indicators

Strong credit growth fuelled the economic cycle. Lenient lending conditions and lax banking regulation encouraged a strong expansion in bank lending. Core country banks lent substantial funds across borders, driving continued growth in the periphery. Much of this credit went to less productive sectors of the economy, such as construction, causing real estate price bubbles to develop in several countries. A period of low nominal interest rates convinced markets that the rapidly accumulating private debt stock in these countries (Figure 5) was affordable.

Lax lending conditions led to credit expansion especially in the periphery, fanning real estate price bubbles.

Figure 5: Private sector debt
(as a % of gross domestic product)

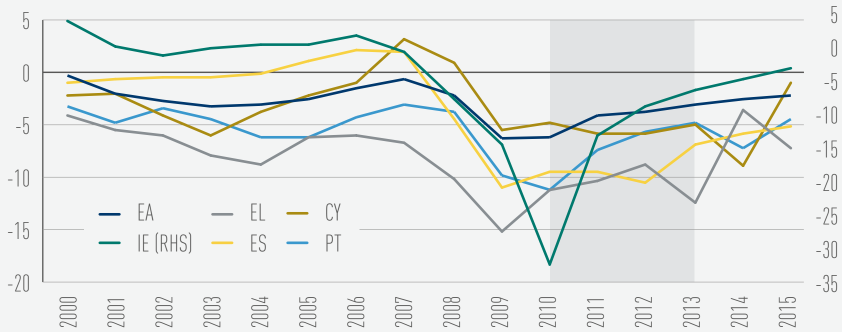


Notes: The grey block represents the height of the sovereign debt crisis. Data for 2015 is until Q3.
Sources: AMECO, Bank of Inernational Settlements, and Haver Analytics

Incentives for necessary reforms were lacking.

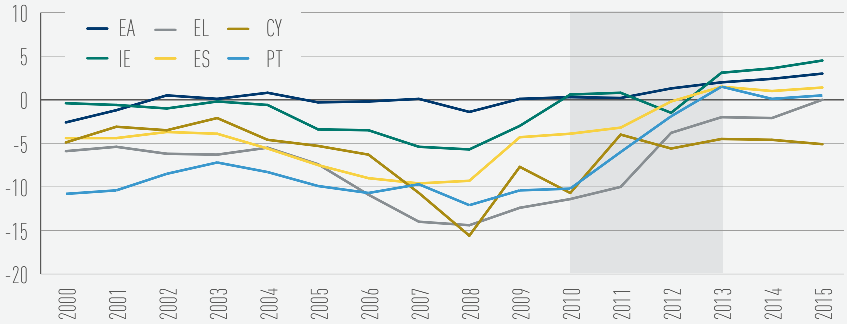
Policymakers failed to react to these growing economic imbalances or to seize upon high growth to cushion their budgets in the event of a downturn. Many countries continued to run large nominal or structural budget deficits (Figure 6), with the surpluses in Ireland and Spain reliant on the revenue from transaction-based taxes, such as stamp duties or other property-related levies. Tax revenues collapsed during the downturn due to narrow tax bases. Growing expenditures bloated the public sector. At the euro area level, savings from the core continued to fund current account deficits (Figure 7) in the periphery. The assumption of risk-free euro area sovereign debt kept markets from raising interest rates on those countries with rising fiscal and current account deficits. Low inflation allowed for low nominal interest rates, which facilitated the expansion of credit.

Figure 6: Nominal budget balance
(as a % of gross domestic product)



Note: The grey block represents the height of the sovereign debt crisis.
Sources: Eurostat and Haver Analytics

Figure 7: Current account balance
(as a % of gross domestic product)



Note: The grey block represents the height of the sovereign debt crisis.
Sources: International Monetary Fund's World Economic Outlook and Haver Analytics

The onset of the global financial crisis exposed the underlying economic weaknesses, and raised market concerns over countries' abilities to rectify these problems. The subsequent increase in their bond yields forced several to request loans from the official sector. The deepening recession following the global financial crisis exacerbated existing fiscal and banking problems in the programme countries. Although they shared these common problems, each country also faced challenges of differing type and magnitude.

The crisis laid bare the underlying economic weaknesses and compounded existing problems.

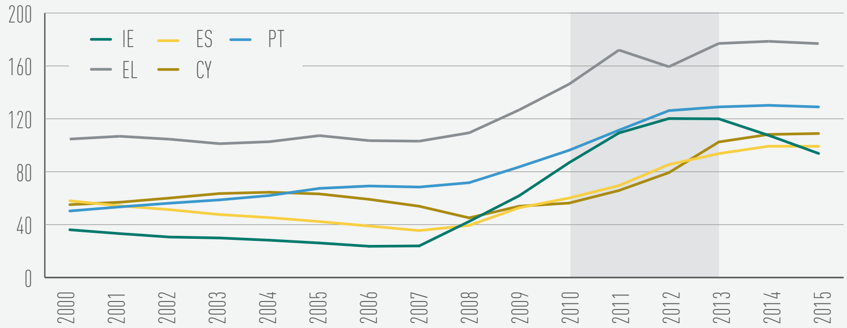
Greece required the most significant effort, with fiscal and current account deficits of 15.2% and 14.4%, respectively, as well as considerable structural rigidities. Ireland also required a large adjustment, given a sizeable general government deficit of 12.6% of GDP in 2011, and the need for further injections of capital into the banking sector – despite past recapitalisations worth almost 28% of GDP. Portugal, burdened by a highly indebted private sector and a deep recession, had its budget deficit climb to 9.2% before it entered a programme. For Cyprus and Spain, their weakening economies and deteriorating banking sectors drove their fiscal deficits to a maximum of 5.7% in 2011 and 11% of GDP in 2009, respectively. Each adjustment programme was designed to tackle country-specific problems.

Countries shared problems such as external debt, market barriers, ailing banks, and ballooning budget deficits.

Restoring fiscal sustainability and external competitiveness were the immediate focus of all the programmes, with the exception of Spain's, which focused solely on the financial sector. Excessive deficits required frontloading fiscal consolidation, with both cuts in expenditure and increases in revenue needed. Countries mounted a substantial effort as part of the programmes. As a result, they achieved a remarkable improvement in their fiscal position, reflected in substantial declines in their budget deficits (Figure 6). For Greece, worse-than-expected macroeconomic conditions and slippages in programme implementation required a downward revision to their programme's fiscal targets. Falling nominal GDP, however, resulted in a further expansion of these countries' debt-to-GDP ratios (Figure 8) during the programme. Only now are they stabilising.

Country reforms focused successfully on bringing budget deficits down.

Figure 8: Public debt
(as a % of gross domestic product)



Note: The grey block represents the height of the sovereign debt crisis.
Sources: Eurostat and Haver Analytics

Countries also tackled swollen banking sectors, recapitalising some banks and liquidating others.

The programmes also recapitalised and restructured banking sectors. By segregating 'toxic' or impaired assets, channelled in several cases into 'bad banks', countries endeavoured to deleverage outsized banking sectors. They injected significant funds to help recapitalise viable banks, and they liquidated insolvent ones. The reforms worked to modernise the banking sector, strengthen supervisory frameworks, and improve legislation for insolvency and the management of NPLs.

Single Supervisory Mechanism tests show banks are now more robust.

The programmes assigned approximately 20% of programme funds, on average, for bank recapitalisation in Ireland, Cyprus, and Portugal. In Spain, the complete focus of the programme on the financial sector meant that bank recapitalisation funds comprised the entire financing package. In the end, none of the countries needed more than half the funds originally allocated for the recapitalisations. The recent Single Supervisory Mechanism (SSM) stress tests show that the programme countries improved their capacity to deal with risks and withstand losses.

Most programmes focus on more competition, privatisation, and product and labour market reform.

A strong reform agenda aimed to reverse losses in competitiveness and foster dynamic and flexible business and labour environments. All programmes, with the exception of Spain's, included a series of reforms that sought to enhance competition and remove distortions from product and labour markets. This included a privatisation agenda to shift inefficiently used resources from the public to the private sector's balance sheet. Labour market reforms were also a common element. Reforms also focused on correcting the pre-crisis loss of competitiveness arising from wage growth outpacing productivity. To do so, they reconfigured the wage-setting process and helped reallocate labour to the most productive sectors. They also made cuts in public sector pay and pensions.

Labour market reforms and privatisations proved the hardest to implement.

Greece needed to introduce the most ambitious set of reforms. It reduced the minimum wage by 22% (32% for new labour market entrants), decentralised wage bargaining, and cut excessive public sector employment by 150,000. Cyprus, Ireland, and Portugal also initiated similar reforms that included greater flexibility, streamlined working hours, and overtime payments. Unfavourable market conditions and the ongoing need to address existing rigidities slowed the pace of privatisation plans in most programme countries. Only Portugal managed to exceed expectations, with proceeds reaching €9 billion compared to a target of €5.5 billion.

European support proved vital in facilitating programme countries' reforms and improving their financial condition. The crisis, however, left them with high unemployment, NPLs, and still significant domestic and external debt levels. As the recession gathered strength and the fiscal adjustment started, unemployment levels rose substantially, especially for the young. Up to 2013, unemployment grew by 12.5 percentage points (pp) on average in programme countries, far more than the average 4.5 pp increase in the overall euro area. Greece and Spain suffered the largest cumulative rises, of 19 pp and 17 pp, respectively, between 2007 and 2013. However, over the last two years, and in line with the broader economic recovery, unemployment has started to decline in all programme countries. Although it remains above pre-crisis levels, it is projected to continue trending lower.

The programmes could not immediately reverse the consequences of the recession.

The large fiscal deficits of programme countries made it necessary to frontload fiscal consolidation. Because this consolidation took place during a severe recession, disposable incomes fell substantially and led to a significant deterioration of banking sectors' loan books. With disposable income dropping by an average of almost 16%, NPLs in Ireland, Spain, and Portugal rose above the euro area average. In Greece and Cyprus, disposable income dropped by close to 27%, while NPLs exceeded 50%. Programme strategies to reduce banks' exposures, combined with climbing disposable income as economies re-emerge from recession, should address this challenge and equip the banking sector to boost lending and relaunch investment in the private sector.

As a result, banks' NPL burden shot higher but programme work on banks should address this.

Persistently large fiscal deficits and the need for bank recapitalisations pushed public debt up sharply despite consolidation measures. Starting from levels far below the euro area average, debt quintupled in Ireland, tripled in Spain, and almost doubled in Cyprus during the financial crisis. In Portugal and Greece, which started with more public debt, the total rose by almost 65 pp. Recovering economic growth and narrowing deficits, however, ensure that public debt has started to decline from its peak in all programme countries except Greece.

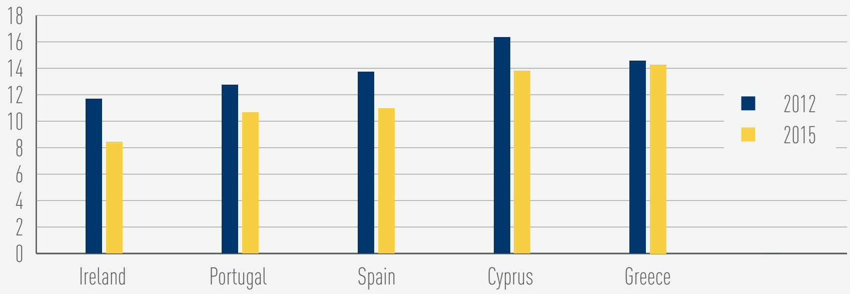
Debt also mushroomed but has since started to decline in all programme countries except Greece.

The countries' substantial efforts during their programmes have begun to produce positive results, with economic recoveries underway and clear improvements in budgetary and debt sustainability. This was also the case in Greece, until the combination of a reversal of implemented reforms and protracted negotiations with official creditors led to a deterioration in the economy and banking sector. The fiscal measures introduced during the programmes,[2] especially pension reforms, have enhanced the medium- and long-term sustainability of public finances. They strengthened the countries' abilities to absorb future costs, in particular those related to ageing populations (Figure 9).

Structural reforms and fiscal consolidation are correcting imbalances.

[2] The pension reforms in Spain were not part of the programme conditionality.

Figure 9: Projected public pension costs in 2060
(as a % gross domestic product)

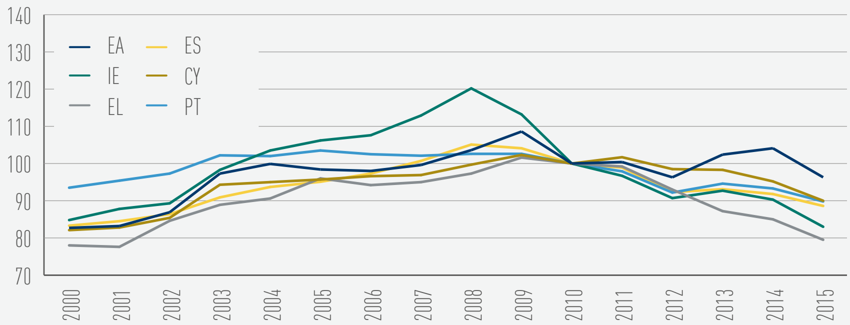


Source: European Commission 2015 Ageing Report

Current account balances, for example, are improving.

Current account surpluses have significantly reduced external imbalances. A dramatic drop in imports initially drove this as domestic demand fell. However, as competitiveness improved during the programme period, exports expanded significantly. Price and wage restraint, facilitated by structural reforms, has resulted in a large real effective exchange rate depreciation. In Greece, Ireland, and Portugal this rate has dropped to its lowest level since the introduction of the euro – a clear sign of improvement (Figure 10).

Figure 10: Real effective exchange rate
(2010=100)



Source: AMECO; based on comparison of unit labour costs with 37 industrialised countries

Increasing exports mean that economic growth is more sustainable.

Increasing exports mean that economic growth is now less reliant on the credit-fuelled rise in domestic demand witnessed before the crisis. Reduced unit labour costs from labour market reforms, coupled with a business friendly environment from product market reforms, should encourage entrepreneurship and attract investment in the medium term (Figure 4). The fact that economic growth is occurring in the absence of credit growth suggests that private sector dependence on debt is gradually declining, and points to a more efficient and sustainable allocation of domestic savings.

Greek adjustment is ongoing. The first two programmes resulted in substantial improvements. By 2014, Greece had enhanced its competitiveness and growth dynamics and stabilised its financial sector. Political uncertainty and protracted negotiations with official creditors, however, caused severe disruption during 2015. A return to recession and a weakening of the financial sector necessitated a new ESM programme. Full and timely implementation of this new programme should enable Greece to follow in the footsteps of other programme countries, staging a return to growth and overcoming its reliance on official lending.

Full and timely implementation of its third programme should help Greece return to growth, too.

The support programmes helped countries fix economic and structural failings, paving the way for sustainable growth. In compensation for short-term costs, countries finishing their programmes will enjoy substantial medium-term gains. These include resilient banking sectors, sustainable fiscal and external balances, and positive growth prospects. Looking ahead, safeguarding these important gains is a key challenge.

Loan programmes help countries fix problems, regain access to affordable market finance, and resume growth.

Continued structural reforms will help countries maintain their competitiveness. Given the ageing of the European population, future growth prospects depend upon productivity gains that in turn require countries to continue reforming their economies. This will help preserve flexible labour markets, modern banking sectors, a business friendly environment, and efficient product and service markets. These efforts should go hand in hand with prudent policies that safeguard fiscal and debt sustainability. Derailing – by rolling back programme reforms, relaxing reform momentum, or reinstating fiscal and external deficits – would put the gains from the programme adjustments at risk. It would also cast doubt on future growth potential, with negative implications for debt sustainability.

But remaining on a sustainable path requires countries to continue to reform their economies.

MACROECONOMIC AND FINANCIAL ENVIRONMENT

The euro area continued to recover in 2015, with the economy expanding at a moderate pace. Headline inflation dropped to zero, reacting to a collapse in oil prices. The European Central Bank (ECB) responded to the lacklustre inflation with bold monetary policy easing designed to push it up towards the ECB's inflation aim of close to, but below, 2%.

Yet while the ECB, and many other central banks, were aggressively easing policy, the U.S. Federal Reserve began to raise interest rates in December. The anticipation of this divergence in monetary policies across major economies set the tone for equity markets during the year, which responded with bouts of high volatility. Sovereign bond yields dropped to historical lows, with an ever-broader universe of bonds falling to negative yields.

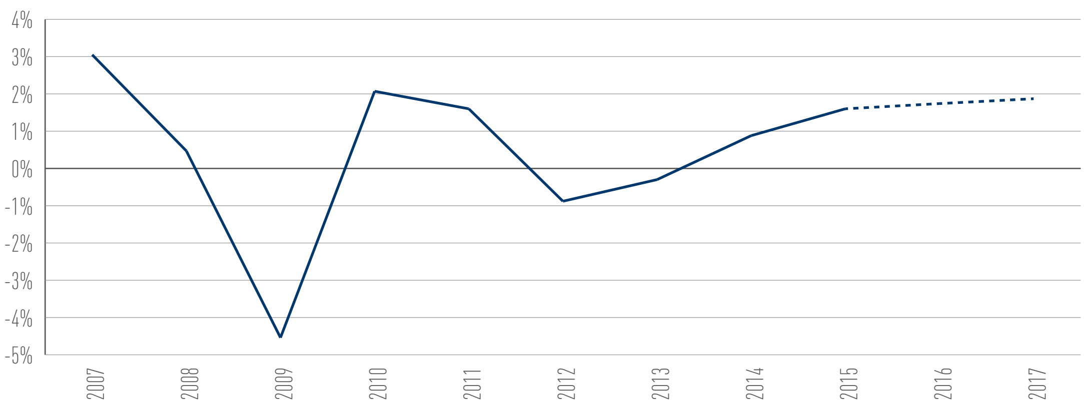
Looking ahead, the euro area economy is expected to continue its gradual recovery. Risks stem in large part from a slowdown in emerging markets, a number of geopolitical concerns that keep economic uncertainty elevated and the negative impact of persistent weakness in commodities markets on prices.

Moderate recovery continues

In 2015, the euro area economy grew moderately. It drew strength from a decline in oil prices, a low euro exchange rate, exceptionally accommodative monetary policy, low financing costs and, following substantial consolidation, a return to a broadly neutral fiscal stance (Figures 11, 12 and 13). However, a slowdown in the global economy and emerging markets in particular weighed on euro area growth. Persisting geopolitical tensions, volatility in commodity and financial markets, and the Greek political crisis in the first half of the year fed economic uncertainty and hampered investment activity. Finally, the economic crisis aggravated some legacy problems such as excessive private and public indebtedness, a large stock of NPLs, and high structural unemployment, keeping growth on a tight leash. Nevertheless, growth for the euro area as a whole was above potential, thus narrowing the output gap.

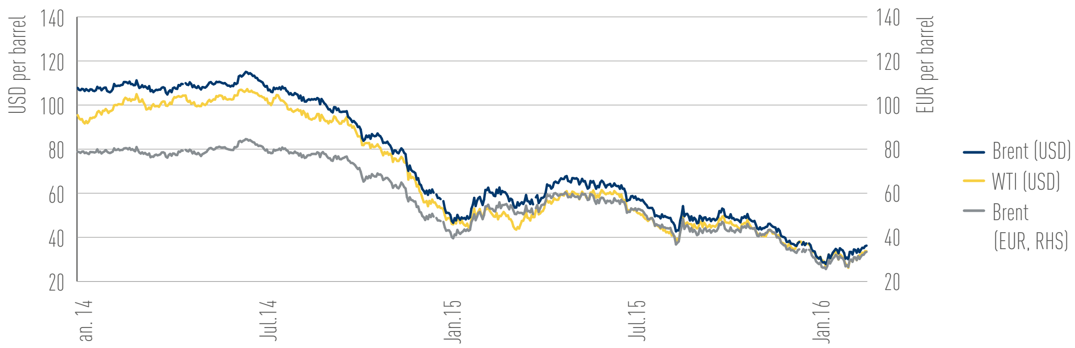
Albeit gradual, the recovery is broad-based both in composition and geography. Private consumption (Figure 14) provided the main engine for GDP growth, as households' real purchasing power rose due to low inflation and rising employment. Government

Figure 11: Euro area real gross domestic product growth



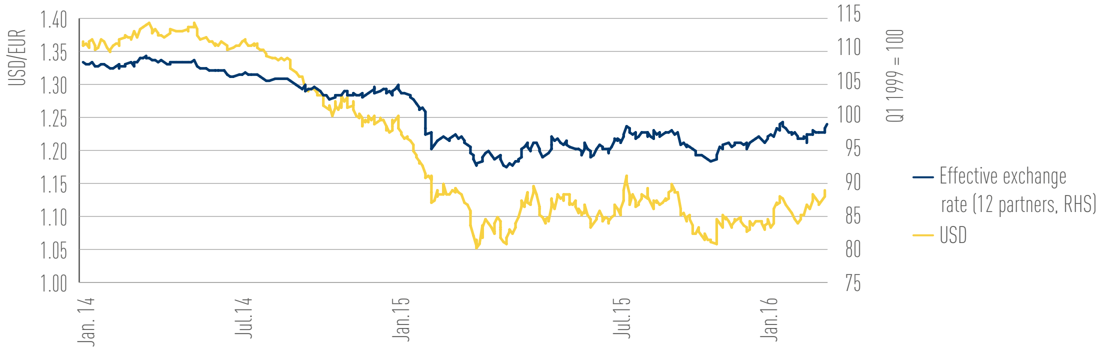
Source: European Commission Economic Forecast Winter 2016 consumption also gained momentum owing to the broadly neutral fiscal stance and additional public spending prompted by the inflow of migrants. Medium- to long-term growth prospects hinge largely on accelerating investment, which remains more sluggish than following previous crises. External trade was a drag on GDP growth as demand for euro area exports from weakening trade partners slowed.

Figure 12: Oil prices



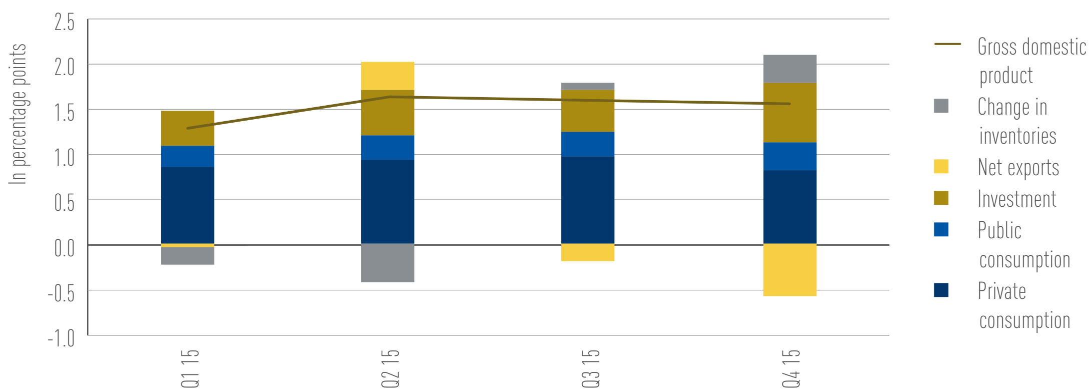
Source: Bloomberg

Figure 13: Euro exchange rate



Sources: European Central Bank and Bloomberg

Figure 14: Contributions to annual gross domestic product growth



Source: Eurostat

Economic growth accelerated in the vast majority of euro area countries. All countries except Greece grew, according to preliminary estimates, confirming the strength of the recovery. GDP growth in larger euro area economies converged in 2015. Surprises among smaller countries were mainly on the upside. Countries that implemented more reforms, including the former programme countries, outperformed those with persistent macroeconomic imbalances and structural flaws.

Stronger economic activity improved conditions in the euro area labour market. Employment growth accelerated further. The unemployment rate declined for the second consecutive year, although it remains well above pre-crisis levels. High unemployment, and very high youth unemployment in particular, in several countries remains one of the most pressing problems facing the euro area economy.

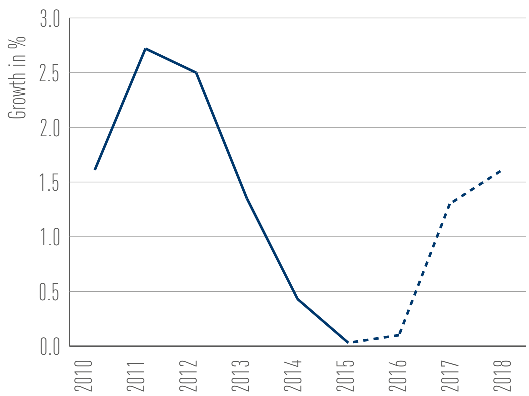
Inflation remains very low

Headline inflation rates fell to zero in 2015 as oil prices declined (Figure 15), but core inflation accelerated. Considered a better indicator of underlying inflationary trends than headline inflation because it excludes volatile energy and unprocessed food prices, core inflation slowly gathered momentum to reach around 1% towards the end of the year (Figure 16). While that still leaves core inflation well below the ECB's aim for headline inflation of close to, but below 2%, it also puts it at a relatively safe distance from deflation territory. Subdued wage developments and the gap between actual and potential output, which remains negative and is closing only slowly, are curbing a pick-up in core inflation.

Moreover, the upward trend in core inflation stalled at the beginning of 2016, potentially indicating the start of second-round effects from very low energy prices.

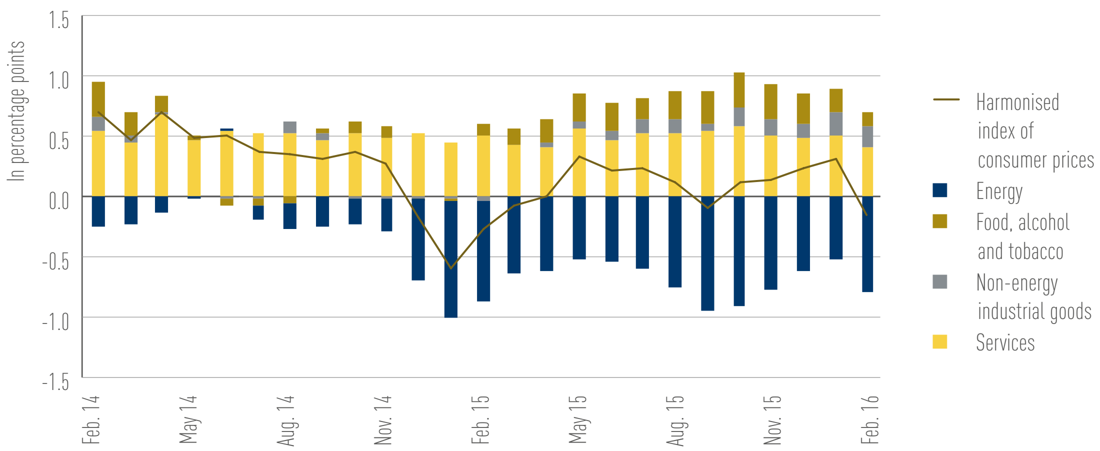
Inflation rates at the country level converged somewhat during 2015, but diverged again in the first months of 2016. In large economies inflation stayed close to the euro area average. Inflation rates in countries undergoing internal devaluations got closer to or reached positive ground at the end of 2015, but disinflationary pressures prevailed again in the first quarter of 2016.

Figure 15: Harmonised index of consumer prices



Source: European Central Bank Staff Macroeconomic Projections March 2016

Figure 16: Contributions to harmonised index of consumer price inflation rate



Source: Eurostat

Macroeconomic policies provide exceptional support

To counter weak price developments, the ECB substantially eased monetary policy, resorting to additional unconventional measures. The ECB repeatedly recalibrated its monetary stimulus, aiming to return headline inflation to its inflation aim, while also preventing the de-anchoring of medium-term inflation expectations. In January 2015, the ECB announced and in March began large-scale purchases of government bonds and bonds of selected supranational institutions, also referred to as quantitative easing. It followed this up in December with a cut in the deposit rate of 10 basis points to -0.3% and reinforced its forward guidance by extending the intended horizon of the asset purchase programme until at least March 2017 from September 2016.

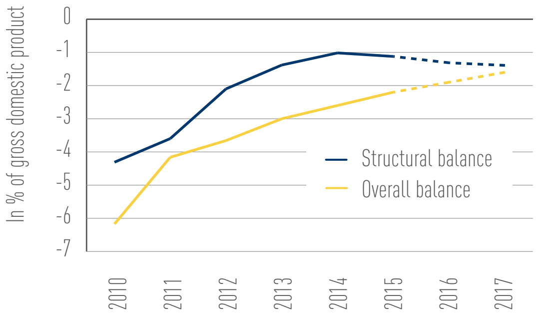
Despite these steps, mounting downside risks to the inflation outlook at the beginning of 2016 triggered further resolute monetary policy action in March 2016. The ECB cut the deposit rate by another 10 basis points and other policy rates by five basis points. It raised monthly purchases under the quantitative easing programme to €80 billion from €60 billion and decided to expand its list of eligible assets to include corporate bonds. Finally, it launched a new round of targeted long-term refinancing operations. To improve the transmission of financing to the real economy, the cost of the operations charged to participating banks can be as low as the ECB's deposit rate, which is currently negative. A counterparty bank can benefit from such very low interest rates if it supplies amounts of loans above a benchmark to the real economy.

The accommodative monetary policy improved credit conditions. Growth in loans to both non-financial corporations and households picked up pace in 2015, with consumer credit gaining particular momentum. The ECB's Bank Lending Survey showed an overall loosening in the credit standards applied to loan approvals and in new loan terms and conditions. It also reported an increase in demand for credit in all segments.

The aggregate euro area fiscal stance returned to broadly neutral in 2015, another plus for economic activity. The budgetary plans for 2016 suggest that this stance could turn mildly expansionary going forward. Fiscal policy in many countries remains caught between the need to ensure sustainable public finances as enshrined in European fiscal rules and the stabilisation function. To help countries resolve this dilemma, the flexibility of the Stability and Growth Pact has been significantly increased, in particular in its preventive arm. The revised interpretation of the Pact allows more gradual fiscal adjustment in bad economic times; it also increases flexibility in connection with structural reforms and public investment. In the same vein, countries with sufficient fiscal space have been invited to consider fiscal stimulus. An increased emphasis is put on the growth-friendly character of fiscal policies. They focus in particular on: avoiding cuts in expenditure that boost long-term growth; reducing taxation of labour; and shifting the tax burden towards less distortionary taxes.

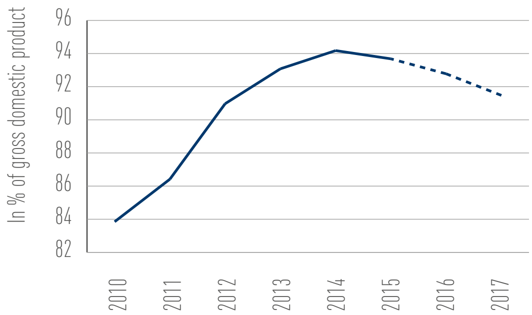
The government budget balance ratio to GDP improved further in 2015, but this improvement did not stem from fiscal consolidation. Instead, it was driven by the cyclical budgetary component amid the economic recovery and interest savings from the large drop in sovereign borrowing costs. Fiscal consolidation came to a standstill (Figure 17). The government debt ratio declined in 2015 for the first time since the beginning of the crisis (Figure 18). Many euro area countries' significant consolidation efforts brought about this turnaround, as did stronger economic growth and a decreasing interest burden. While the relationship between inflation and public finances is not trivial, the low inflation environment puts additional pressure on budgets in the short run. Negative inflation surprises have a direct and immediate impact on revenue, whereas expenditure (usually budgeted in nominal terms) adjusts only gradually.

Figure 17: Euro area government budget balances



Source: European Commission Economic Forecast Winter 2016

Figure 18: Euro area government debt



Note: The Commission's euro area debt forecast is, unlike Eurostat data, not consolidated for bilateral intergovernmental lending and financial assistance provided via the EFSF.
Source: European Commission Economic Forecast Winter 2016

Euro area bond yields fall deeper into negative territory, while equities set new highs

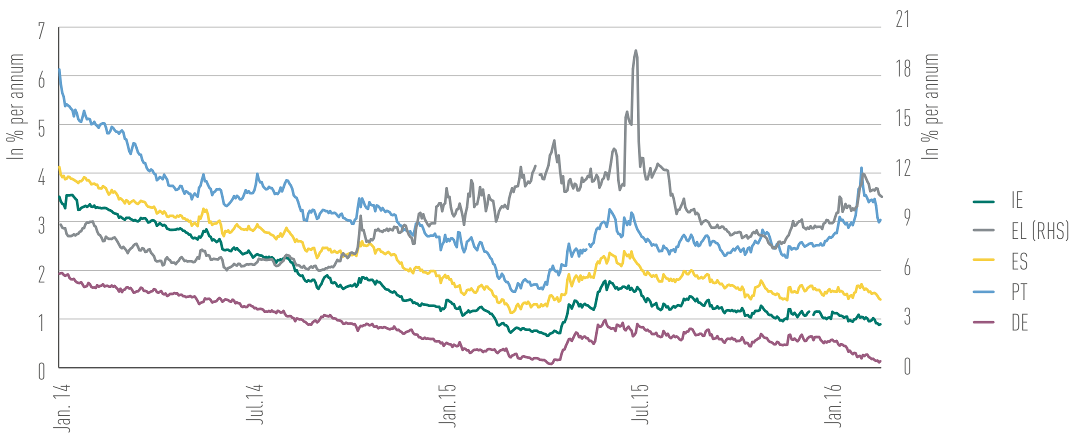
In 2015, the biggest global drivers of financial asset prices were expectations of the divergence in monetary policies across major advanced economies, with most easing policy, while the U.S. Federal Reserve began to raise rates. In the euro area, the year started with an expansion of the European Central Bank's asset purchase programme to combat persistently low inflation. China lowered rates five consecutive times during the year while devaluing its currency. In the U.S., the Federal Reserve raised its main policy rate in December as it closed in on its unemployment and inflation mandates. In January 2016, the Bank of Japan unexpectedly lowered rates to negative territory. Numerous other central banks took bold steps in defending their economies in the same period and asset prices followed suit.

Against this background of diverging economic paths, asset prices displayed greater volatility. During the first half of 2015, equity indices set new record highs. The second half was less benign, epitomised by a dramatic fall in the 24 August flash crash. Global equities then staged an impressive comeback in the last quarter but proved unable to maintain this into the new year. In the first months of 2016, fears of tighter dollar funding conditions and weaker demand from other parts of the world ultimately led to a collapse in equity prices.

The ECB, faced with deteriorating sentiment during the first half of 2015, committed to stepping up its support, thereby boosting euro area sovereign bond markets. In March last year, the ECB's accommodative policy pushed sovereign yields to historical lows (Figure 19), with an ever-broader universe of bonds reaching negative yields. The record-low German Bund yield of seven basis points in April 2015 did not persist as Bunds sold off to reach a yield of 98 basis points less than two months later. Since then, sovereign bond yields benefited from a flight to safety and gradually reverted lower. Intra-euro area bond spreads remained broadly constant to German yields while corporate bond yields closely followed the direction set by sovereigns. Exactly one year later, Bund yields are displaying a similar pattern: yields have again fallen to as low as eight basis points and corporate bond yields decreased sharply as the ECB stepped up its asset purchase programme.

For similar macroeconomic concerns, energy and commodity prices continued to fall throughout the year. Lower-than-expected demand from China, production levels that did not adjust, and rising oil inventories all contributed to oil trading under 40 dollars per barrel, well below breakeven prices for most oil-producing countries. Commodity-dependent emerging market economies worsened in particular, as exports of their dollar-denominated raw materials lost value and weighed more heavily on declining financial resources. The energy and commodity price falls exacerbated in turn the effects of substantial capital flight that occurred in the summer market sell-off. These events prompted a number of central banks to ease monetary policy and in some cases intervene in foreign exchange markets.

Figure 19: Selected 10-year sovereign yields



Source: Bloomberg

While 2015 was certainly not a calm year, financial markets virtually imploded as 2016 began. The growing sense of weakness at the end of the preceding year manifested itself through a sharp sell-off in Chinese equity markets, which rapidly spread through advanced economies. Commodities fell further, with oil tumbling to as low as 28 dollars per barrel in February. While there may have been a fundamental rationale, the sell-off appeared to be indiscriminate. European banks in particular were hit hard in early February due to wide-ranging concerns about the viability of and risks associated with the sector. Bank equity valuations fell to their lowest levels since 2012 and in some cases even lower. After more than a month of pronounced weakness, markets regained some composure in the middle of February.

Outlook remains positive, but risks still high

The euro area economy is expected to continue its gradual recovery. Inflation should accelerate as soon as the direct negative impact from the decline in oil prices unwinds and the underlying inflationary trends take hold. The economic outlook is, however, subject to downside risks. Geopolitical tensions remain high, keeping uncertainty elevated. The slowdown in emerging market economies has only been gradual so far, but a more dramatic drop in economic activity might have negative consequences for the global economy, world trade, and the demand for euro area exports. The large recent inflow of migrants represents an opportunity in the longer run, but it poses important short-run challenges. As to prices, the biggest downside risk stems from second-round effects of the massive drop in oil prices on non-energy components.

On the positive side, euro area economic growth could speed up more than currently anticipated, provided that external risks fail to materialise and domestic, mainly political risks, are properly handled. That would clear the way for a combination of multiple growth-enhancing factors like low oil prices, favourable financing conditions, and overall exceptionally loose macroeconomic policies to boost growth more than currently expected.

Financial markets will be affected by further monetary policy divergence. Central banks cast an ever-bigger shadow over markets, whose deficiencies appear increasingly common in some areas. By design of quantitative easing, investors are reallocating financial resources to other asset classes, which may raise concerns about the financial stability implications of further central bank action. In turn, the strain put on commodity-exporting countries can give rise to further regional financial stability problems.

PROGRAMME COUNTRY EXPERIENCES

Former programme country

Ireland

Ireland's economic recovery gathered further momentum in 2015, driven by domestic demand and exports. For the second year running, Ireland was the fastest-growing economy in Europe. The increased economic activity boosted tax revenues and ensured the achievement of fiscal targets. Ireland therefore exits the Excessive Deficit Procedure (EDP) on schedule, having met the deficit targets specified under the European Union procedure for five years in a row. Favourable market conditions facilitated Ireland's early repayment of the most expensive portion of its IMF loans. The well-capitalised banks improved their profitability, despite a persistently, albeit significantly reduced, high level of NPLs.

Irish economic growth accelerated in 2015. As measured by GDP, it rose by 7.8%. Gross national product (GNP), which strips out the effect of the important multinational sector, grew by 5.7%. As the profits earned by the mainly foreign-owned multinational sector eventually flow back to their parent companies abroad, the growth in GDP in Ireland is often not indicative of the improvement in national income. Both GDP and GNP per capita surpassed their pre-crisis peaks. Ireland became, for the second year in a row, the fastest-growing economy in Europe.

Economic activity increased in almost all sectors, with Irish exporters benefitting greatly from a weaker euro exchange rate and lower oil prices. A surge in domestic demand implies that economic growth is less reliant on the export sector. Consumer spending recovered and is now close to its pre-crisis peak. Investment is rising, but purchases of intangibles – such as royalties on patents – are a large component. These purchases could turn out to represent just a one-off increase if the multinational sector, or foreign-owned subsidiaries of larger companies based abroad, is taking advantage of favourable tax rates and provisions for tax planning operations.

The unemployment rate continued to decrease, from a peak of 15.1% in early 2012, and stood at 8.6% in March 2016, well below the euro area average. House price increases eased throughout the year as the new macroprudential policies that the Central Bank of Ireland introduced began to take hold. A current account surplus indicates the continued unwinding of external imbalances, although issues such as contract manufacturing and aircraft leasing complicate any assessment of Ireland's external position.

Ireland outperformed on the fiscal side, despite enacting an expansionary 2015 budget. A deficit of 2.3% of GDP means that Ireland will meet its Excessive Deficit Procedure (EDP) target for the fifth consecutive year and it will therefore exit the EDP and hence the corrective arm of the Stability and Growth Pact on schedule. This is despite Eurostat's decision to classify the redemption and conversion of its remaining preference shares in

AIB, of around 1% of GDP, as general government expenditure. The fiscal outperformance stemmed from higher-than-expected tax revenues, as expenditure was above 2015 budget projections. It is unclear, however, whether the exceptionally large increase in corporation tax receipts is a structural change or a one-off phenomenon.

Ireland's debt-to-GDP ratio is falling rapidly, given a primary surplus of 0.8% of GDP in 2015, coupled with the strong increase in nominal growth, and decreasing debt interest payments. The debt ratio fell to 93.8% of GDP in 2015; down from 107.5% in 2014. Ireland's substantial holdings of financial assets mean net debt is just below 80% of GDP.

The positive performance of the Irish economy and the ECB's quantitative easing programme helped keep Irish bond yields subdued throughout the year – spreads vis-à-vis Germany were by far the lowest of any country that was in a programme. Ireland issued €13 billion of government bonds in 2015 at a weighted average yield of just over 1.5%, and a weighted average maturity of just under 18 years, managing to lock in low rates and long maturities. Ireland completed the early repayment of the full portion of its IMF loans that were subject to surcharges, thereby delivering significant interest savings. The strong economic growth and improved public finances resulted in both S&P and Fitch upgrading Ireland's credit rating last year, to A+ and A- respectively. Moody's continues to rate the Irish sovereign lower at Baa1.

The process of repairing the banking sector is proceeding well, but weaknesses remain. Banks continue to improve their profitability, reduce their impaired assets, and strengthen their capital ratios, while the State continues its programme of disposing of its banking assets to the private sector. The Irish banking sector has returned to profitability as a whole thanks to a lower cost of funding, largely driven by customer deposit inflow and the reversal of provisions that had been set aside to handle losses on NPLs. New loan generation, albeit growing, is insufficient to counter the decline in total assets. In 2015, the stock of NPLs substantially decreased, but they remain high and are the most problematic issue that banks need to tackle in the near future. After the recent recapitalisation of Permanent TSB, all the banks have adequate capital buffers.

Ongoing Early Warning System monitoring to assess Ireland's ability to repay its loans shows that the country currently faces no difficulty in meeting these repayments. The large increase in discretionary spending at the end of the year, however, was a missed opportunity to reduce the budget deficit further even though Ireland broadly achieved the budget deficit target for 2015. The announcement of another expansionary budget for 2016 shows a declining commitment to fiscal discipline, with the European Commission noting that, while Ireland is broadly compliant with the provisions of the Stability and Growth Pact, there is some risk of deviation from the adjustment path towards the medium-term objective.

The European Financial Stability Facility is born

The signing ceremony establishing the euro area's temporary rescue fund, the European Financial Stability Facility (EFSF), on 7 June 2010. The EFSF, which turned five in 2015, stopped accepting new programmes in July 2013, after having loaned €188 billion for programmes to three countries. The euro area countries launched the EFSF's first programme in Ireland, followed by Portugal and then Greece. Though it no longer accepts new programmes, the EFSF will continue to manage its loan repayments, issue debt, and make payments to bondholders. (Credit: AFP/George Gobet)

New ESM programme

Greece

In the first half of 2015, significant political uncertainty linked in part to a reversal of previously implemented reforms and to protracted negotiations between the newly elected Greek government and its official lenders severely undermined market sentiment and the banking sector. In June 2015, after having gone into arrears with the International Monetary Fund (IMF), the Greek government implemented a bank holiday and capital controls. In the end, Greece and its official sector creditors agreed on a three-year ESM economic adjustment programme of up to €86 billion. The new programme aims to safeguard previous programme achievements, strengthen the country's financial stability, and return it to a sustainable growth path based on sound public finances and enhanced competitiveness. By the end of the year, the economy had stabilised, proving more resilient than expected. Programme implementation, most notably the completion of the bank recapitalisation in December 2015, helped steady the economy. Looking ahead, Greece needs to take full ownership of the programme and put forward credible and effective policies to reach agreed programme targets, regain market access, and put the economy on a firm and sustainable footing.

In the first half of 2015, the Greek government was heading for a political standoff with its official lenders, exacerbating liquidity distress and reversing the growth momentum that had emerged in 2014. Funding stress in the banking sector intensified as political uncertainty induced massive deposit outflows and the stock of NPLs increased. The Bank of Greece started providing emergency liquidity assistance as Greek banks were not eligible for normal monetary operations. In response, all rating agencies took negative credit rating decisions on Greece. Yields on Greek government bonds climbed, in contrast to the declining bond yields for other euro area sovereigns.

The EFSF lending facility expired at the end of June 2015. In the absence of official financing and without market access, Greece faced severe liquidity constraints that eventually led to failure in servicing external debt obligations with the IMF and the Bank of Greece. This constituted a default event under EFSF lending agreements. On 3 July 2015, the EFSF decided to reserve its right to accelerate the repayment of its facilities.

The political tensions culminated in a referendum on 5 July 2015 which resulted in the rejection of potential programme conditions. To protect the banking sector from a bank run, the government imposed bank holidays and capital controls on 29 June 2015 and the Athens stock exchange was closed on 27 June. The economic and financial situation became increasingly untenable and on 8 July 2015, Greece made an official request for stability support – in the form of a loan facility – to the ESM. The acute liquidity shortage was temporarily addressed with a bridge loan on 20 July 2015, under the European Financial Stabilisation Mechanism (EFSM), clearing arrears with the IMF.

After the political agreement in the Euro summit in July, the Greek authorities passed several sets of required reform legislation, so-called prior actions, in July and August 2015. The ESM approved the new programme on 19 August 2015, with available financing of up to €86 billion over three years. This amount could be reduced, given that earmarked amounts for bank recapitalisation were not fully needed. Such a reduction would also depend on IMF participation and on Greece's success in implementing policy reforms that would enable it to resume market financing before 2018. Under the programme, the Greek government committed to several reforms, including: restoring fiscal sustainability; safeguarding financial stability; boosting growth, competitiveness and investment; and reforming the public administration. The first disbursement was made in August 2015, in part to repay the short-term bridge loan disbursed under the EFSM, while earmarking €10 billion for bank recapitalisation and resolution. The recapitalisation of systemically relevant banks was successfully completed in December 2015 and only required €5.4 billion. By December 2015, the entire amount of the first tranche to be released in cash, €16 billion, had been disbursed. Given that the Greek government had cleared its arrears with the IMF and the new ESM financial assistance programme was in place, the EFSF decided to waive its rights with respect to the events of default tied to Greece's obligations towards the IMF and the Bank of Greece.

The economy stabilised at the end of 2015 and proved more resilient than expected, benefitting from successful programme implementation. Capital controls, in particular, exerted a less detrimental influence than predicted. According to the Greek statistical agency's first estimate, real GDP declined by 0.2% in 2015, as private consumption and net exports almost fully offset the negative impact of investment, while public consumption remained broadly stable. In 2015, the external adjustment continued and the current account neared zero following a deficit of 2.1% of GDP in the previous year.

Eurostat data confirm that in 2015 the government achieved a primary surplus of around 0.7% of GDP according to the programme definition against a target of -0.25% of GDP. The general government debt ratio declined by 3.2 percentage points to 176.9% in 2015, but may increase again in the coming years. Despite these developments, concerns remain regarding the sustainability of Greece's public debt. These concerns should be addressed through strong programme implementation. Euro area partners stand ready to consider, if necessary, possible additional measures aiming at ensuring that Greece's gross financing needs remain at a sustainable level. These measures will be conditional upon full implementation of the measures agreed in the ESM programme and will be considered after the first positive completion of a programme review.

But important challenges still lie ahead. Medium-term fiscal stability necessitates, among other measures, an income tax overhaul and a pension reform to ensure the sustainability of the social security system. For the banking sector to remain viable, the elevated stock of NPLs must be reduced, thereby supporting credit growth and relaunching investment in the private sector. Reforms to modernise the banking sector are also critical to restoring its soundness. The privatisation programme should be pursued without undue political interference. Only timely and successful programme implementation will unlock programme funds for arrears clearance to inject liquidity into the business sector.

Despite earlier programme achievements and a stabilising economy, conditions for the real economy and the financial sector remain challenging. Greece cannot afford delays in programme implementation or a new phase of excessive political uncertainty if the economy is to benefit fully from the improvements already achieved under the third adjustment programme. The Greek government and official sector creditors must keep building a trusting relationship and the Greek government needs to take full ownership of the programme and act in its spirit.

The three financial assistance programmes for Greece

I FIRST PROGRAMME

Initial programme amount: €110 billion
Total amount disbursed: €73 billion

Lenders: Euro area countries (except Slovakia) under Greek Loan Facility (GLF) managed by European Commission: €52.9 billion; IMF: €20.1 billion

Grace period and maturity on GLF loans extended to 10 and 30 years from three and five years, respectively.

Interest rate: priced with 3-month Euribor with a margin lowered to 50 basis points from 300 for GLF; IMF – around 3.96%

Key legislated reforms: pension system, institution building, state budget, public sector benefits

II SECOND PROGRAMME

Initial programme amount: €165.4 billion
Total amount disbursed: €153.8 billion

Lenders: EFSF: €141.8 billion (including €48.2 billion for bank recapitalisation, €34.6 billion for private sector involvement and bond interest facilities) of which €10.9 billion for bank recapitalisation were not used by the HFSF and were returned to the EFSF

Maximum weighted average maturity on EFSF loans extended to a maximum 32.5 years from 7.5

Interest rate: guarantee fee cancelled on EFSF loans and some interest payments deferred by 10 years; IMF – between 2.85% and 3.78%

Key legislated reforms: labour market, income tax, public administration, structural reforms

III THIRD PROGRAMME

Total amount committed: up to €86 billion

Lenders: ESM: up to €86 billion (including up to €25 billion for bank recapitalisation); IMF: to be determined

Maximum weighted average maturity: 32.5 years

Interest rate for cash disbursements: 0.72% (end December 2015)

Key legislated reforms: VAT, public financial management (fiscal council), corporate and household insolvency law, tax administration

EUROPEAN DEBT RELIEF BENEFITS GREECE

Euro area countries have taken many steps to ease Greece's overall repayment burden.

Euro area Member States have taken several steps to ease the lending terms for Greece to support its ability to service its debt burden, principally through lower financing costs and a longer repayment period. Nominal haircuts on the debt have not been undertaken.

First Greek programme (no EFSF or ESM involvement)

In the first programme, euro area countries cut borrowing rates, and put off and extended the repayment period.

When Greece first asked for financial assistance from the EU, there was no lender of last resort for governments yet. Under that programme, known as the Greek Loan Facility (GLF), euro area countries lent Greece €52.9 billion on a bilateral basis, and the IMF another €20.1 billion.

Begun in April 2010, the programme was amended in June 2011:

- the maturity was extended by five to 10 years,
- the grace period was lengthened to 4.5 from three years,
- the margin was lowered by 100 basis points, to 2% in the first three years and 3% thereafter.

This change was replaced by the second amendment in March 2012:

- maturities were extended to 15 years,
- the grace period raised to 10 years,
- the margin was further reduced to 150 basis points over the entire period.

Second Greek programme (EFSF involvement)

In the second, they adopt another similar set of measures.

The EFSF, Europe's temporary rescue fund, had already been in operation for nearly two years when the second Greek assistance programme began in March 2012. In November of that year, this second programme introduced additional debt alleviation measures. Worse-than-expected macroeconomic developments, missed targets, and prolonged policy uncertainty meant additional measures needed to be taken to reduce financing needs and to support the sustainability of Greek government debt. Therefore, the Eurogroup approved a broader set of measures on the GLF and EFSF loans:

- reduction of the GLF interest rate margin by 100 basis points;
- cancellation of the EFSF guarantee commitment fee;
- deferral of EFSF interest payments on loans under the Greek Master Financial Assistance Facility Agreement by 10 years;[3]
- return of the Securities Markets Programme (SMP) profits (when the ECB bought Greek government bonds with a discount in the secondary market and made a profit at maturity);
- extension of the GLF to 30 years and EFSF weighted average maturities to 32.5 from 17.5 years.

[3] Not applied to Private Sector Involvement (PSI) and bond interest facilities, which correspond to roughly 25% of the overall EFSF loan to Greece.

Third Greek programme (ESM programme)

In August 2015, Europe's permanent rescue fund, the ESM, launched the third programme for Greece. As of 31 December 2015, it had disbursed €21.4 billion to Greece under this programme of up to €86 billion total agreed financial assistance. This programme was needed to help Greece tackle worsening macroeconomic conditions and a serious deterioration in the banking sector. The weighted average maturity of the loans to Greece was fixed at 32.5 years and lending rates were, as in all programmes, based on the ESM's low cost of funding.

In 2015, the ESM took on the third programme for Greece.

Low financing costs

The low financing costs of the European facilities reduced Greece's debt servicing burden, thereby providing authorities with greater fiscal flexibility. The GLF, the EFSF, and ESM rates are well below market rates for Greece. The EFSF and ESM lending rates (excluding fees) stood at 1.57% and 0.72%, respectively, as of end-December 2015. The EFSF and ESM rates compare favourably with the 2015 IMF lending rate of around 3.8%.([4]) They also remain far below the roughly 5% rates that Greece had to pay for corresponding maturities before the crisis and its current market rates. Financing at the EFSF, ESM, and GLF rates therefore entails an important support component compared to other sources of financing.

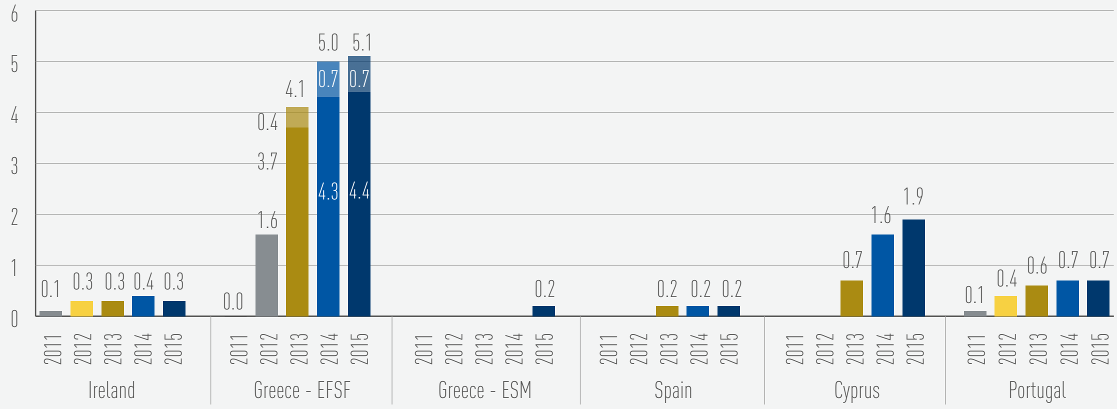
The low financing costs of the European facilities create fiscal space.

As far as EFSF/ESM financial assistance is concerned, the simplest way to estimate the savings achieved over the past years is to compare the effective interest rate payments on EFSF/ESM loans with the interest rate that these countries would have paid had they been able to cover their financing needs in the market in the absence of disruption. The proposed approach values every single disbursement in the past at the average market 10-year bond yield in a year.([5])

([4]) For 2016, the implicit interest rate is projected to reach 3.10% by end-December 2016, assuming no new disbursements.

([5]) The market interest rate is capped at a maximum of 6.4%, which represents the highest rate at which euro area countries issued a bond over the past eight years. This cap is imposed because secondary bond markets do not provide reliable pricing information at times of distress given very high rates.

Figure 20: Potential budgetary savings from EFSF/ESM low cost of financing
(in % GDP)



Source: ESM

The EFSF and ESM pass on their low financing costs to the borrowing country.

Figure 20 shows the savings for Greece and the other countries benefitting from EFSF/ESM financial assistance. Savings are presented as a percentage of GDP. The deferral of interest payments granted to Greece on EFSF loans is depicted in light colour. The figure shows that all countries benefitted from low interest rates, though the financial advantage is by far the largest for Greece given the massive size of the financial support. Benefits increased in all cases with the disbursement of the programme. They have slightly decreased recently for Ireland in view of its improved financing conditions. However this effect is expected to be temporary, when the more expensive loans provided initially under EFSF mature.[6] The deferral of interest rates, which was only granted to Greece in view of its special debt challenges, provides an additional advantage in current budgetary savings, representing a total 5.1% of GDP in 2015. The deferred payments will, however, become due after 2022.

Effective reduction of the debt burden

Greece benefits in the long run through a more sustainable debt burden.

The measures correspond to substantial economic debt relief. Considering the maturity extensions and interest rate deferrals over the entire debt servicing profile from a net present value (NPV) perspective shows a reduction in the overall debt burden. The NPV approach consists of discounting the difference between the future cash flows of the loans with lower financing costs and debt relief measures and the cash flows of such loans had they not benefitted from the relief measures. Stretching out principal repayment schedules over such an extended period of time, along with interest payment deferral, imply that these payments account for substantially less in NPV terms for Greece from a financial market perspective.[7]

The reduction of the debt burden in NPV terms and savings from the various relief measures described above leads to NPV savings equivalent to 51% of Greece's 2015 GDP. Excluding ANFA and SMP profits, the debt relief for Greece in NPV terms rep-

[6] See also the section on lending in Chapter 2.

[7] It should be noted that this does not entail any financial loss or writedown from an EFSF perspective. The EFSF is fully repaid; Greece has to cover any financing costs related to the agreed interest rate deferral in line with the amendment of the Master Financial Assistance Facility Agreement.

resents 40% of outstanding debt to European official creditors; this, however, implies no reduction in nominal debt and therefore no cost for the European taxpayer.

The overall savings figure comprises first an NPV reduction for the EFSF facilities of 32% of GDP, of which 3% of GDP can be attributed to the extension of maturities and interest rate deferral, and 29% of GDP can be attributed to the savings from the low financing rate. The ESM disbursed facilities as of end of 2015 created another NPV reduction of 5% of GDP thanks to favourable financing rates. To these numbers, one can add the impact of the extension of maturities and the lowering of the margin for the GLF. This generated another 9% NPV savings of GDP. Finally, the return of SMP profits added up to 5% of GDP.

This overall NPV savings figure and its breakdown is based on assumptions of the interest Greece would have to pay on the market, compared to estimates of the future EFSF cost of funding.[8] Figure 21 summarises the breakdown of overall savings.

The ESM calculates those NPV gains at 51% of Greek 2015 GDP.

Debt repayment

The debt relief measures taken by its European creditors represent a substantial benefit in fiscal space and overall payment profile for Greece. Payment obligations are minimal until 2023. Thereafter, the repayments stretch out over several decades. The favourable lending rates and the lengthy repayment periods were considered adequate at the time to safeguard the sustainability of Greek debt provided that Greece continued its reform agenda.

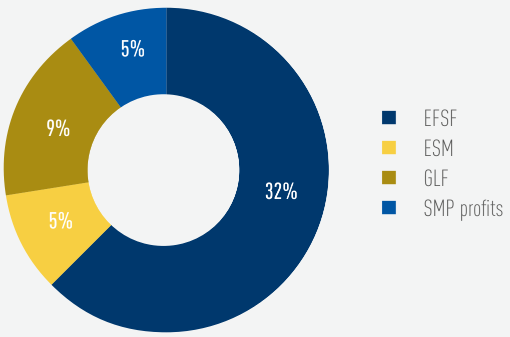
Views on how to best assess debt sustainability are evolving. There is a growing consensus in line with the EFSF/ESM view that debt sustainability depends not only on the overall amount of liabilities, but also on the underlying debt structure, in particular its maturity. On this score, key to debt sustainability are:

- a downward sloping path for the overall debt stock, and
- a sufficiently modest level of annual gross financing needs, a metric which reflects the fiscal stance and debt service flows.

To assess the sustainability of debt, one must consider more than its overall amount.

[8] Estimates of future EFSF and ESM cost of funding are based on expected interest rates (forward rates) derived from market data which are applied to future EFSF and ESM funding volumes. The rates Greece would have to pay on the market are based on the EFSF and ESM cost of funding plus estimates of spreads.

Figure 21: Long-run net present value savings for Greece from European financial support (in % gross domestic product)



Source: ESM

Former programme country

Spain

Strengthening domestic demand boosted growth in 2015, although that expansion was slowed by weak external demand. The Spanish sovereign maintained good access to capital markets, while the banking sector continued on the path to recovery. The stock of NPLs decreased at a fast pace, with positive implications for profitability. Political uncertainty has further delayed fiscal consolidation and put on hold the privatisation of the two remaining state-owned banks.

The economy consolidated its recovery in 2015. Overall, GDP growth reached 3.2%. Domestic demand contributed with 3.7 pp, outweighing the negative contribution from the external sector. The good performance of Spanish exports, more resilient than European peers, was outweighed by strong import growth. In nominal terms, however, the current account registered for the third straight year a surplus equivalent to 1.5% of GDP (1.0% in 2014), as lower energy prices and borrowing costs mitigated the effect of higher import volumes. Strong job creation supported by continued wage moderation and the impact of labour market reform triggered a gradual decrease in the unemployment rate to below 21% (20.9%) at the end of the period. Enhanced confidence and positive tailwinds in 2016 from low oil prices and an accommodative ECB monetary stance are expected to support the growth momentum, though some deceleration is foreseen due to the global trade slowdown.

The general government deficit reached 5.1% of GDP in 2015, a reduction of 0.8 pp from 2014. This result represented an almost one pp deviation from the target agreed under the EU Excessive Deficit Procedure. In 2015, public revenues registered an annual growth rate of 2.9% and public expenditure grew at a 1.2% rate, driven by higher compensation of employees (including the return of 2012's Christmas bonus to public employees) and an increase in public investment. The reduction of debt interest payments limited the higher expenditure. By budgetary sub-sector, the deviation was concentrated on social security (with a deficit of 1.3% of GDP, 0.7 percentage points above target) and the autonomous regions (-1.7% against the -0.7% targeted), partially offset by a better-than-expected performance by the central government and local corporations.

As the December 2015 elections failed to produce a stable government, Spain endured a protracted period of political uncertainty well into the first half of 2016. The deviation in the public deficit in 2015 has confronted the caretaker government with the need

to introduce new measures to correct the imbalances in public accounts before the end of the year.

The Spanish sovereign maintained good access to capital markets, despite greater financial volatility in the second half of the year. All in all, in 2015 the risk premium on Spanish 10-year bonds compressed by 120 basis points on average, and the yield declined by 100 basis points driven by the low oil price environment, better economic performance, and European Central Bank (ECB) interventions.

Spanish banks' financial condition kept improving in 2015, thanks to better asset quality, a strong liquidity position, and satisfactory capitalisation. Banks' asset quality, as measured by the non-performing loan (NPL) ratio, is edging closer to the euro area average, although it is still two pp higher in Spain. The stock of NPLs decreased in 2015 (-2.2% year-on-year, end of period), which, together with a moderate fall in credit stock (-3.8%), lowered the NPL ratio by more than two points from year-end 2014 to 10.1%. The gradual recovery in domestic activity – especially in the housing sector – should support further improvement in 2016. Profitability has improved, though unevenly.

Bank liquidity improved further. Spanish banks reduced their reliance on central bank liquidity, as the deposit base stayed strong and market access remained open, despite periods of heightened volatility. In addition, all significant banks in the system satisfy their capital requirements, as set by the Single Supervisory Mechanism.

Since the fourth post-programme mission in October 2015, economic and financial indicators have continued to perform positively. Political challenges remain a source of concern, with the uncertainty over the formation of a new government delaying fiscal adjustment and potentially causing friction with the markets. The ESM's Early Warning System exercise provides an ongoing positive assessment of Spain's ability to honour its ESM loan payments. With public debt at 99.2% of GDP in December 2015, down from 99.3% of GDP registered in 2014, and nominal GDP growth constrained by subdued inflation rates, a credible fiscal strategy and strong reform momentum are key to dampening the consequences of potential financial market turbulence.

Programme concluded March 2016

Cyprus

Cyprus exited successfully from its ESM programme on 31 March 2016, using in the end only 70% of the about €9 billion ESM package and no follow-up financial assistance facility. Over 2015 and early 2016, it continued reaping the benefits of the reforms undertaken since the start of the programme. In 2015, Cyprus exceeded programme targets in some key areas, such as on the fiscal side. While banks' NPLs remained very high, the banking sector's overall health continued to improve and capital controls were fully lifted in April 2015. Structural reforms lagged, however. It is crucial that Cyprus actively manages the NPLs and continues pursuing sound policies post-programme to improve long-term growth prospects further.

Cyprus returned to growth in 2015 after three years of recession. Annualised GDP grew at 1.6%, slightly better than expected in the most recent forecasts. Domestic demand growth of 2.9% largely drove this improvement. Net exports contributed negatively with 1.3%, as imports expanded at almost double the pace of exports. The labour market started to recover, too. The unemployment rate declined to 13.1% in December 2015 from 16.8% in December 2014. Still, unemployment remains very high and far above the 10% registered in early 2012. Competitiveness continued to improve as unit labour costs fell again in 2015. Inflation remained marginally negative primarily due to the drop in oil prices.

Cyprus was broadly on track with fiscal adjustment and fiscal reform measures in 2015. The general government headline deficit declined to approximately 1% of GDP versus 8.9% in 2014. The higher-than-expected primary surplus increased to 1.8% in 2015 from a deficit of 6% in 2014. The debt-to-GDP ratio reached 108.9% in 2015, a marginal increase from 108.2% in 2014. Some of the reforms, however, fell behind schedule in late 2015, in particular those related to privatisation.

The banking sector's fundamentals improved further. An injection of additional capital in 2015 strengthened capitalisation, but excessively high NPLs weighed on profitability and the outlook. Although the NPL stock remained overly high in international comparison, it is expected to decline soon. The necessary legal frameworks aimed at reducing NPLs are now in place and banks have stepped up the pace and quality of NPL restructuring. By maintaining the current pace of restructurings, NPLs could decrease at a faster pace than observed in other programme countries.

Growth and fiscal performance helped Cyprus regain market access and allowed it to smoothly exit its ESM programme without any follow-up arrangement. Cyprus sovereign bond yields declined substantially. The 10-year yield reached around 3.8% at the end of 2015. Over the programme period, Cyprus also built strong cash buffers and achieved a very solid maturity profile. While Cyprus regained market confidence, its credit ratings remained below investment grade. To keep market perceptions positive and regain investment grade, the determined implementation of reforms remains essential.

The need for reforms continues beyond the programme's end. Effective NPL reduction, modernising the governance of state-owned enterprises, further improving the efficiency of the public sector, and ensuring labour market flexibility will all strengthen Cyprus's long-term growth potential and attractiveness as an investment destination. Reunification of the country, if ongoing talks succeed, would provide further opportunities for investment and growth.

Jeroen Dijsselbloem, Eurogroup President and Chairperson of the ESM Board of Governors (centre), talks with Klaus Regling, ESM Managing Director (left) and Harris Georgiades, Finance Minister of Cyprus (right) at the 7 March 2016 Eurogroup meeting, the final meeting before Cyprus successfully completes its loan programme.
(Credit: European Union 2016 – Source Council of the European Union)

ESM CONDUCTS TWO TECHNICAL ASSISTANCE PROJECTS IN CYPRUS

At the request of the Cypriot authorities, the ESM delivered technical assistance to the Public Debt Management Office (PDMO) of Cyprus on its core work and also assessed and made recommendations to the Cyprus Treasury on how to assess and manage the risks of its government guarantees.

In one project, the ESM focused on optimising the PDMO's core work and strengthening its risk management. The ESM assisted the PDMO in defining its organisational structure, including on information technology infrastructure, internal controls, and staffing. It also looked at enhancing its market intelligence function, covering investor relations and the communication of market information.

In the other, the ESM analysed the risk of Cypriot government guarantees and made recommendations on the methodology for assessing and managing that risk.

Former programme country

Portugal

The Portuguese economic expansion gained momentum in 2015. Domestic demand continued to recuperate and exports to increase, however a rise in imports meant that trade weighed on economic growth. The correction of fiscal and external imbalances continued, but the external adjustment lost momentum. To keep market confidence, Portugal should continue to implement the reforms agreed under the Stability and Growth Pact. Banking sector fundamentals have stabilised, but vulnerabilities remain as the resolution actions taken in December 2015 demonstrate.

GDP expanded by 1.5% in 2015. As in the previous year, domestic demand was the main contributor and expanded by 2.5%, with private consumption increasing by 2.6%. Although net trade reduced growth by 1.0 percentage point, that deficit narrowed from 2014. Despite an export increase of more than 5%, imports accelerated further and expanded by more than 7% on the back of strong domestic demand. The current account balance improved again and reached a surplus of 0.7% of GDP, compared to 0.3% in 2014.

The budget deficit continued to decline, to 4.4% of GDP in 2015 from 7.2% in 2014 or, if one excludes one-off factors related to bank recapitalisations, to around 3% of GDP in 2015 from 4.2% in 2014. The deficit is therefore above the EDP target of 2.5% of GDP. This decline in the deficit was mostly due to an over-performance in revenues, primarily from improved domestic demand and from a significantly stepped-up fight against tax evasion. Unlike in previous years, government spending met the budget target. Nevertheless, it still increased due to wage rises following constitutional court rulings from previous years.

Government debt decreased to 129% of GDP from 130.2% in 2014. This stock of debt included a cash buffer of close to €8 billion (4.4% of GDP) held by the Debt Management Office, IGCP – down from €15 billion at the end of 2014.

Financial market perceptions have deteriorated since October 2015 and particularly in the first months of 2016, due to renewed banking sector concerns and the implications for public finances, amplified by the political uncertainty that followed the general election. Government bond yields and spreads versus Germany increased to levels regis-

tered before the end of the financial assistance programme in 2014. Nevertheless, Portugal continued to be able to tap the market, through both syndicated and regular auctions. Portugal was also able to repay early a significant proportion of its IMF loans subject to surcharges. This operation facilitated a lengthening of the average maturity of public debt and will help smooth redemption peaks in the coming years.

In general, banking sector fundamentals are slowly stabilising while important vulnerabilities remain. Banks have been capitalised over the past years and the banking sector capital level stood at 11.6% of risk weighted assets (CET1 ratio) at end-2015. Nevertheless, the capital ratios of a few banks could come under pressure if their profitability does not improve further. Profitability climbed in the first half of 2015 on the back of lower costs of risk and funding, but it receded again in the second half. NPLs are still increasing but the inflow has slowed. The stock is high at more than 15% of total gross loans. The supervisor intends to push banks to tackle the problem quickly. Portuguese banks also traditionally have a large exposure to developing countries and in particular to Angola. Since Angola is suffering from the global decline in oil prices, this vulnerability must be monitored going forward.

At the end of 2015, the banking sector faced heightened volatility driven by resolution actions. The resolution authority decided to move senior bonds back to Banco Espirito Santo from Novo Banco, which effectively implied a bail-in of these liabilities.([9]) This move, while positive for Novo Banco and its capital situation, caused significant volatility in the market for Portuguese bank debt. The resolution fund restarted the sales process for Novo Banco in January 2016, which will be preceded by its thorough restructuring. Banif was another major resolution case that surprised markets. The Portuguese state intervened and the bank's good part was eventually sold to Santander Totta. Other banks would have to pick up any resolution fund losses, undermining profitability.

Ongoing Early Warning System monitoring shows that Portugal currently faces no difficulty in meeting its loan service repayments. Despite the positive economic and fiscal developments in 2015, the sustainability of Portuguese government debt remains challenging given its size and the still weak growth prospects for the coming years. The challenging fiscal prospects together with the recent turbulence in the Portuguese bond market do not allow room to stray from the reform path. The reversal of some of the reforms implemented during the programme will reduce Portugal's competitiveness. To keep market confidence, Portugal should comply with the agreed fiscal targets under the Excessive Deficit Procedure and continue to implement the structural reforms agreed under the European framework.

([9]) On 28 April 2016, a local court ruling put this resolution on hold.

NON-PERFORMING LOAN BURDEN CURBS LENDING, HOLDS BACK GROWTH

Excessive post-crisis NPL stocks curtail banks' lending capacity and limit growth.

The recent economic and financial crisis led many households and companies to default on bank loans. European banks carry this large stock of NPLs on their balance sheets – the single largest legacy of the past crisis. The NPLs lock banks' potential lending capacity. During the euro area crisis, the stock of NPLs increased by more than 300% to €928 billion as of end-September 2015 from €292 billion as of end-December 2007.

Distribution of NPLs is uneven, burdening the banks most in the periphery countries.

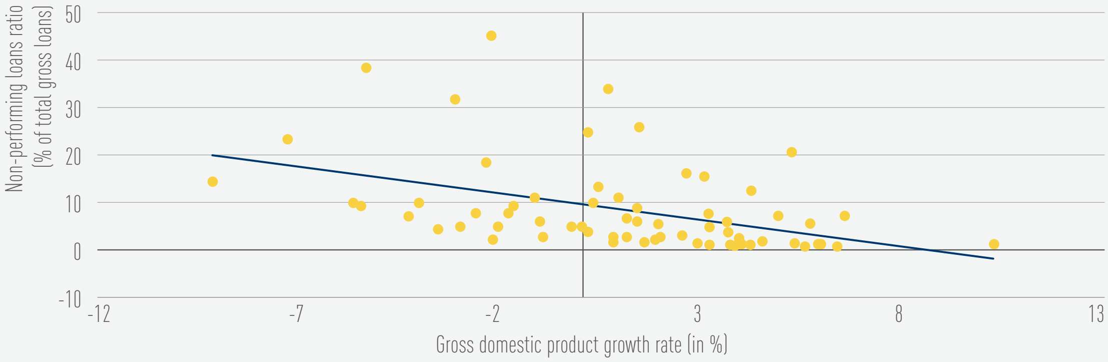
NPLs are distributed unevenly across the euro area, with banks in crisis-hit periphery countries[10] holding more than two thirds of the total for the euro area as a whole. The proportion of bank capital that NPLs absorb rose to 8.1% as of end-September 2015 from 1.6% as of end-2007. At the beginning of the financial crisis, NPLs absorbed roughly the same proportion of banks' capital in both groups of countries (1.6%). By end-September 2015, however, this ratio had climbed to 14% in the peripheral countries versus a more limited 4% in the core countries. Different NPL dynamics explain in part why the banks in the two regions reported diverging profitability during the crisis.

NPLs have peaked and the provision coverage has increased.

While the stock of NPLs remains high, the inflow of new NPLs has nearly ceased and provision coverage has risen further. As the NPL provision coverage of 52% at the system level is broadly adequate now, loan loss provisions have started declining and will drag less on profits going forward. For the banks with lower provision coverage, however, the loan loss provisions are likely to decline at a slower pace, hurting profits.

[10] Ireland, Greece, Spain, Italy, Cyprus, Portugal, and Slovenia.

Figure 22: Negative correlation between real growth and non-performing loans in euro area programme countries 2000–2014



Sources: International Monetary Fund Financial Soundness Indicator database and European Central Bank

In the literature, GDP growth emerges as a driver of banks' asset quality and it acts through various channels.[11] Recessions slow consumption, which leads to deteriorating incomes for firms, often putting them under financial pressure and reducing their capacity to repay (Figure 22). In Portugal, for example, about 30% of small- and medium-sized enterprises currently have at least one loan that is not performing. Also, in downturns, unemployment increases, forcing households to default on their loans. Whereas asset quality in mortgages is usually better because of the collateral, consumer credit is frequently in default.

Recessions put firms and households under financial pressure, resulting in loan defaults.

The level of NPLs in the banking sector has an important bearing on credit extension and bank profits going forward. The literature shows that higher levels of capitalisation support lending to the economy, but only if NPL levels sink below a certain threshold. With NPLs under control, banks can refocus on lending activity rather than on dealing with the legacy.

NPLs must decline to a manageable level for lending to regain traction.

Relying solely on GDP growth will not lead to a sufficiently fast decline of NPLs, as other institutional factors are equally relevant. Banks need to use the full range of NPL management tools to achieve a significant and swift reduction. In particular, insolvency frameworks should give them sufficient powers and incentives to come to a rapid solution in cooperation with borrowers. Beyond this, insolvency frameworks should also aim at simplifying and speeding up out-of-court restructurings to help preserve as much economic value as possible. A market for NPLs, including the use of professional restructuring servicers, can also help an economy take care of legacy assets. The programme countries have implemented many such legal changes and efforts should continue. Solving the NPL problem would help banks to restore a level playing field between the core and the periphery. However, there is no one-size-fits-all solution, because: the problem is unevenly distributed among countries; the composition and size of impaired loan portfolios differ; and countries have very different legal frameworks and insolvency procedures.

GDP growth alone will not fix NPLs fast enough, insolvency frameworks and NPL management tools must foster best practice.

[11] See for example Glen, J. and Mondragon-Velez, C. (2011), "Business Cycle Effects on Commercial Bank Loan Portfolio Performance in Developing Economies", International Finance Corporation, January 2011. See also: Ayar et al. (2015), "A Strategy for Resolving Europe's Problem Loans", IMF Staff discussion Note SDN/15/19.

02

ESM ACTIVITIES

HOW THE ESM PROCESSES ITS FINANCIAL TRANSACTIONS

Financial transactions at the ESM are conducted by three different teams: Funding, Investment, and Lending. These teams can be regarded as our 'front offices' – they are responsible for raising funds by issuing bonds and bills; for investing funds – most importantly, investing the paid-in capital from ESM Members; and for providing loans to beneficiary Member States. All the transactions carried out for this purpose need to be validated and processed, which is the area of activity of the ESM's Middle and Back Office Division.

The task of the Middle and Back Office is to correctly record, control, process, pay for and report on every transaction. The Middle Office embeds risk management and control procedures into transaction processing to guarantee that the ESM adheres to its key policies, such as on risk, and does not engage in any detrimental activities. In this way, it helps to protect its assets and reputation. The Back Office ensures that the securities and financial instruments bought or sold are exchanged for the correct amount of money at the appropriate time and with the right counterparty. The ESM has chosen a Middle and Back Office operating model that mixes internal and outsourced activities, some of which are mentioned here.

The following steps provide an overview of how the Middle and Back Office handle financial transactions for the ESM's three front-office teams, Funding, Investment, and Lending.

FUNDING

SECURITIES ISSUANCE

THE FUNDING TEAM:

The front-office Funding team issues securities, specifically bonds or bills, to raise funds for the ESM and the EFSF's financial assistance programmes for beneficiary Member States. Its work is guided by the ESM funding plan and Member State lending needs.

TRADE VALIDATION

THE MIDDLE OFFICE:

- Verifies the accuracy of the issuance.
- Checks that the system can accommodate the new issue.
- Updates the internal database with the new issue.
- Ensures the information on the issue is accurately recorded in the internal information technology system.

TRADE MATCHING

THE BACK OFFICE:

- Orders an external bank or clearing house to check that the ESM trade details match those of the institutions purchasing the securities.
- Instructs the 'custodian' on the characteristics of the issue like the amount, price and maturity, ultimately ensuring a proper settlement process.

The 'custodian' is a specialised financial institution that holds securities and assets for safekeeping in electronic or physical form. The custodian acts as a central information hub, keeping track, for example, of who currently owns the issue, since the original issue purchasers may sell the securities on.

POST-TRADE ACTIVITIES

THE BACK OFFICE:

- Ensures the accuracy and validity of the financial information on the issue.
- Monitors the settlement of all funding trades as well as future cash flows. It uses a standard delivery versus payment (DVP) settlement system, which ensures that delivery is made only if a payment takes place (The system acts as a link between a funds transfer system and a securities transfer system).
- Reports the list of trades executed to the European Investment Bank which takes care of the financial accounting.

INVESTMENT

1

TRADE EXECUTION

THE INVESTMENT TEAM:

The ESM's core investment activities are focused on investing the proceeds of the paid-in capital and the reserve fund, thereby contributing to the ESM's creditworthiness. To do so, it initiates a trade by, for example, selling or buying a security, like a bond or a bill. In this process, it takes into account ESM risk guidelines, predefined limits and investment policy.

2

TRADE VALIDATION

THE MIDDLE OFFICE:

- Closely monitors trading activity.
- Verifies that the trade details are correctly recorded in the system in a timely manner.
- Maintains IT core financial data to ensure all trade details are correct.

3

TRADE MATCHING

THE BACK OFFICE:

- Liaises with the outsourced Back Office provider and sends them all ESM investment securities trade details for settlement purposes.

4

POST-TRADE ACTIVITIES

THE BACK OFFICE:

- Closely monitors the settlement process.
- Monitors coupon and redemption income as well as cash needs or excess cash.
- Performs cash and securities reconciliation.

THE MIDDLE OFFICE:

- Reports on daily investment trade activities and positions.
- Reports any breach of investment guidelines (limits checks, concentration risk, liquidity risk), operational risk issues, audit trails and/or limit transgression.
- Checks off-market trade prices.
- Monitors financial instruments valuation.

'Reconciling' an account means ensuring and documenting that an account balance is correct.

LENDING

1

LOAN GRANTING

THE LENDING TEAM:

Structures, negotiates, and implements the loans that are a pillar of the ESM's financial assistance programmes to beneficiary Member States.

2

TRADE VALIDATION

THE MIDDLE OFFICE:

- Participates in the drafting process of lending documentation (request for funds, acceptance and confirmation notices).
- Maintains IT core financial data to ensure loan details are correct.
- Verifies that the loan details are correctly recorded in the system in a timely manner.

3

TRADE MATCHING

THE BACK OFFICE:

- Executes disbursements in compliance with the lending documentation.

4

POST-TRADE ACTIVITIES

THE BACK OFFICE:

- Monitors in- and outflows to and from beneficiary Member States.
- Performs cash and securities reconciliation.

THE MIDDLE OFFICE:

- Produces invoices for all the countries under a financial assistance programme.

LENDING ACTIVITIES

- **ESM launches new programme for Greece in 2015**
- **Spain steps up early loan repayments**
- **ESM disburses €600 million to Cyprus**

Greece

Greek public finances reached the breaking point in early July 2015. Greece missed a debt payment to the International Monetary Fund (IMF). As the situation worsened, and domestic bank deposit withdrawals climbed, the Greek government closed banks and imposed capital controls. Faced with insufficient liquidity to meet the country's debt obligations, the Greek government asked the ESM for financial assistance on 8 July 2015.

Five days later, the leaders of the euro area countries reached an agreement with Greece. First, the Greek government needed to carry out a set of urgent reforms. Only then could talks on an overarching package start. Both these steps were successfully taken.

The Greek government committed to a far-reaching economic reform package, set out in a Memorandum of Understanding (MoU). The MoU, endorsed by ESM Members and the ESM Board of Governors later that summer, was designed to return the Greek economy to growth and make its debt sustainable. The ESM Board of Directors approved the terms of the financial assistance, which are detailed in the Financial Assistance Facility Agreement (FFA).

On 20 August 2015, the ESM approved the first tranche of funds to Greece of €26 billion and disbursed half that amount, €13 billion. This first

Table 1: ESM disbursements to Greece

TRANCHE	VALUE DATE	MATURITY	AMOUNT (€)	TYPE
1st Tranche, Subtranche A, Disbursement 1	20/08/2015	20/08/2059	€13,000,000,000	
1st Tranche, Subtranche A, Disbursement 2	24/11/2015	20/08/2059	€2,000,000,000	
1st Tranche, Subtranche B, Disbursement 1	01/12/2015		€2,720,000,000	*Bank recap
1st Tranche, Subtranche B, Disbursement 2	08/12/2015		€2,705,660,748	*Bank recap
1st Tranche, Subtranche A, Disbursement 3	23/12/2015	20/08/2059	€1,000,000,000	

Note: * Bank recapitalisation.
Source: ESM

disbursement included a €10 billion bank recapitalisation buffer in the form of ESM notes.

According to the FFA, the ESM will provide Greece with up to €86 billion in financial assistance over three years. Under the loan agreement, the Greek government is to use these funds for debt service, banking sector recapitalisation, and budget financing.

In 2015, the ESM made five disbursements totalling €21.4 billion. Of these funds, the ESM disbursed €16 billion in cash for debt servicing and budget financing. A further €2.7 billion in ESM notes was dedicated to the recapitalisation of Piraeus Bank and a similar amount went to recapitalise National Bank of Greece (Table 1).

The amounts disbursed in cash must be repaid from 2034 to 2059. Amounts disbursed for bank recapitalisations have an interim maturity that matches the maturity of the ESM notes issued. Their final maturity will be in line with the maximum weighted average loan maturity of 32.5 years stipulated in the FFA.

Cyprus

In 2015, the ESM made two disbursements under the Cypriot facility totalling €600 million. The first disbursement of €100 million took place on 15 July 2015, followed by a €500 million disbursement on 8 October 2015.

The three-year Cypriot support programme, which expired in March 2016, was designed to provide up to €10 billion in financial assistance, including an IMF contribution. After the IMF decided to provide 891 million in special drawing rights (SDR), the ESM's maximum contribution was fixed at €8.97 billion. A remaining €2.67 billion from the programme was not disbursed and was cancelled. Cyprus exited the ESM programme on 31 March and cancelled in advance the IMF programme due to end on 14 May.

The loans to Cyprus have a maximum maturity of 20 years and a maximum average maturity of 15 years. At year-end 2015, the weighted average maturity of disbursed loans stood at 14.9 years (Table 2).

Table 2: Funds disbursed to Cyprus (2013–2015)

TRANCHE	VALUE DATE	MATURITY	LOAN AMOUNT	TYPE
Tranche 1	13/05/2013	13/05/2026	€1,000,000,000	
	13/05/2013	13/05/2027	€1,000,000,000	
	26/06/2013	26/06/2028	€1,000,000,000	
Tranche 2	27/09/2013	27/09/2029	€750,000,000	*Bank recap
	27/09/2013	27/09/2030	€750,000,000	*Bank recap
Tranche 3	19/12/2013	19/12/2019	€100,000,000	
Tranche 4	04/04/2014	04/04/2030	€150,000,000	
Tranche 5	09/07/2014	09/07/2031	€600,000,000	
Tranche 6	15/12/2014	15/12/2025	€350,000,000	
Tranche 7	15/07/2015	15/07/2031	€100,000,000	
Tranche 8	08/10/2015	08/10/2029	€200,000,000	
	08/10/2015	08/10/2031	€300,000,000	

Note: * Bank recapitalisation.
Source: ESM

Spain

Spain has already made three voluntary early repayments of its ESM loan since the successful 2013 conclusion of its bank recapitalisation programme.

After an initial voluntary early repayment in 2014, the country made another two in 2015. The repayments, €1.5 billion in March and €2.5 billion in July, reduced the outstanding ESM programme amount to €35.72 billion.

One year earlier, in July 2014, Spain had made a voluntary prepayment of €1.3 billion and a scheduled prepayment of unused funds of €308 million.

The Spanish programme, which ran from June 2012 to the end of 2013, was for up to €100 billion. In the end, Spain needed less than half of this, just €41.33 billion. So when the Spanish facility concluded at the end of 2013, the undrawn amount of €58.67 billion was automatically cancelled.

The maximum maturity was set at 15 years, with a maximum average maturity of 12.5 years. At the end of 2015, the weighted average maturity stood at 12.49 years.

Under the programme, the ESM provided bonds to the Bank of Spain, which received them on behalf of the Kingdom of Spain. The Bank of Spain transferred them to the Fund for Orderly Bank Restructuring (FROB). The FROB used them to recapitalise the four financial institutions it had taken over (Group 1 banks) as well as the Spanish asset management company Sareb (Tables 3 and 4).

Funds from the second disbursement, again through the delivery of ESM bonds, were used to recapitalise four additional Spanish banks, which could not reach the required capital levels through other means (Group 2 banks; Figures 23 and 24).

Table 3: Funds requested by Spain for Group 1 banks

TRANCHE	VALUE DATE	MATURITY	LOAN AMOUNT	TYPE
Tranche 1	11/12/2012	11/12/2022	€6,578,000,000	*Bank recap
	11/12/2012	11/12/2023	€6,578,000,000	Bank recap
	11/12/2012	11/12/2024	€6,578,000,000	Bank recap
	11/12/2012	11/12/2025	€6,578,000,000	Bank recap
	11/12/2012	11/12/2026	€6,578,000,000	Bank recap
	11/12/2012	11/12/2027	€6,578,000,000	Bank recap

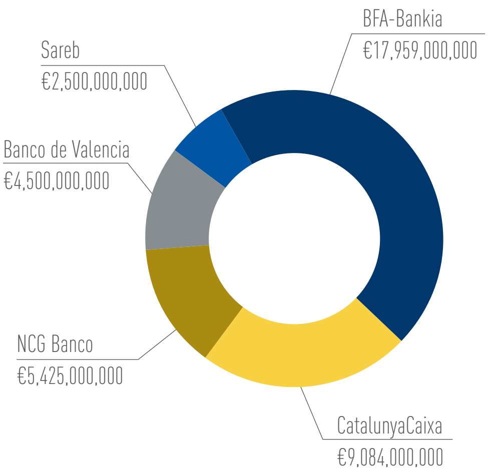
Note: * Bank recapitalisation.
Source: ESM

Table 4: Funds requested by Spain for Group 2 banks

TRANCHE	VALUE DATE	MATURITY	LOAN AMOUNT	TYPE
Tranche 2	05/02/2013	11/12/2024	€932,500,000	*Bank recap
	05/02/2013	11/12/2025	€932,500,000	Bank recap

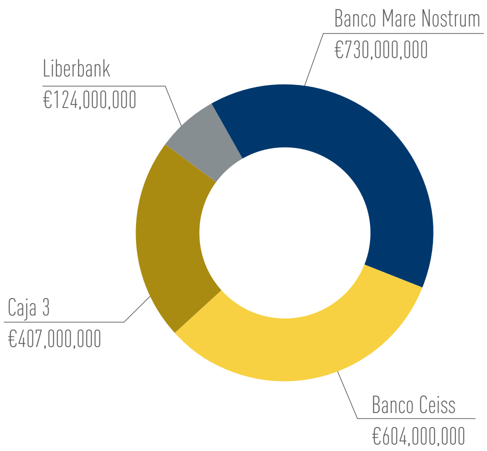
Note: * Bank recapitalisation.
Source: ESM

Figure 23: Split of the funds requested by Spain for Group 1 banks and Sareb



Source: ESM

Figure 24: Split of the funds requested by Spain for Group 2 banks



Source: ESM

HOW THE COST OF FUNDING IS CALCULATED

The EFSF and ESM lending rates aim to fully cover their funding and operational costs and reflect the varying risk profiles of each funding instrument. For this purpose, the ESM and EFSF have used different funding and lending approaches over time:

- Early on, in 2011, the EFSF matched the funds raised from bill and bond sales to a particular programme country's disbursement schedule, called a back-to-back funding or lending strategy.
- Later on, to ensure greater funding efficiency and regular market access, both the EFSF and ESM adopted a diversified funding strategy. Under this strategy, the cash raised was no longer attributed to a particular country; instead, these funds were pooled and disbursed to programme countries. Under this strategy, the rescue funds can use a greater variety of funding instruments across different maturities. This cost of funding is passed on fully to the programme countries, and makes up part of their lending rates. Besides this rate, the ESM and EFSF also charge fees to cover operational costs and margins to cover credit risk.
- To recapitalise banks and finance potential resolution costs, the rescue funds deliver loans in the form of ESM- or EFSF-issued notes, termed 'in kind', as opposed to 'in cash', disbursements.

Pool funding/lending rates

The ESM and EFSF cost of funding rate is a daily per annum rate. This rate reflects the cost that one of the two rescue funds is liable to pay on a given day to investors who hold ESM- or EFSF-issued instruments. The cost of funding rate is derived from a daily computation of the actual interest accrued on either all ESM- or all EFSF-issued debt. Each rescue fund, therefore, has its own funding rate.

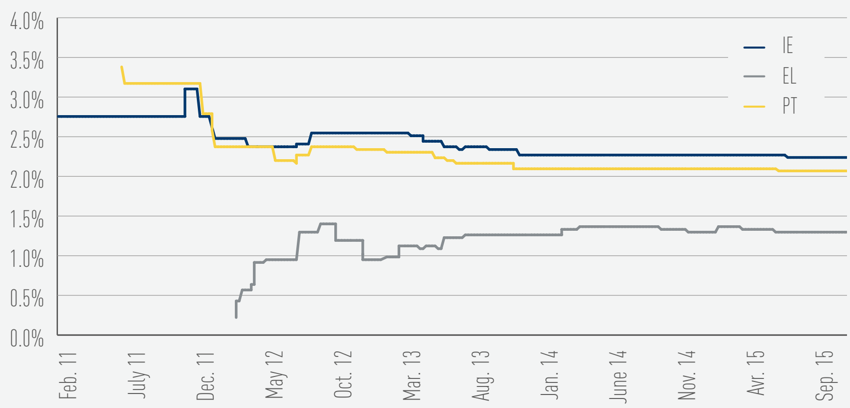
To compute the cost of funding, the same rules apply for both ESM and EFSF rates. The cost of funding rate is computed as a weighted average using four key parameters for each rescue fund. Two parameters are average interest rates on the short- and long-term pools, the other two are so-called 'coverage' ratios, which refer to the share of an ESM or EFSF loan that is covered by the issuance within the short- and long-term pools. The four key parameters therefore are: long-term pool coverage, short-term pool coverage, average interest rate on the long-term pool, and average interest rate on the short-term pool.

Obtaining funding for the long term is more expensive than funding for the short term, so the higher the proportion of the total ESM loan amounts covered by long-term pool funds, the higher the cost of the funding rates.

Blended lending rates

The rescue funds calculate the overall cost of lending to the programme countries, the 'blended lending rate,' for both the EFSF and the ESM. Each is calculated as a weighted average interest rate including the lending costs of all the loans to the programme countries expressed in one single rate. The rate covers the cost of funding for cash disbursements, the back-to-back funding rates, the disbursements in kind, and the fees and margins charged for the assistance. As the structure of disbursements differs across countries, the lending rate may vary somewhat as well.

Figure 25: EFSF historical blended lending rates



Source: ESM

Ireland and Portugal (EFSF)

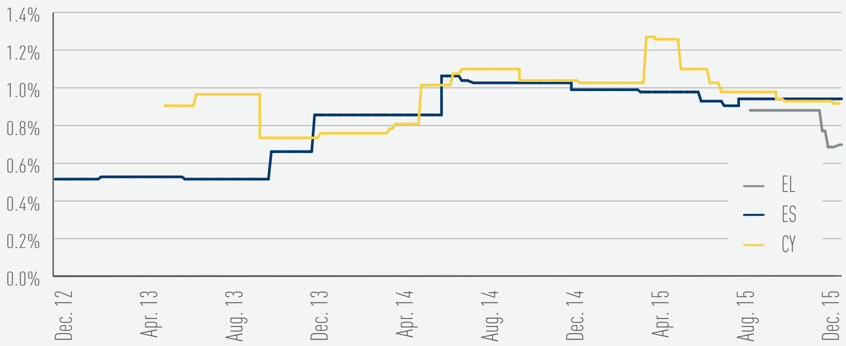
When the EFSF started up activity, it financed loans to Ireland and Portugal through fixed-rate bond issuances on a back-to-back basis. These loans were more expensive at the outset, given a higher interest rate environment at the time, the need for collateralisation, substantially higher margins charged to borrowers, and the fact that the EFSF was a new issuer on the market. From December 2011, after the approval of the diversified funding strategy, the EFSF progressively moved to pool-funded loans, which were initially financed by short-term bills, therefore the rates were lower. Later on, the funding of the loans progressed towards long-term funding instruments, which generated a gradual increase in the cost of funding in 2012. From the beginning of 2013, the rates decreased slightly due to a low-rate environment and have remained moderately stable (Figure 25).

Lending rates for Ireland and Portugal started off more expensive but rates have since fallen and are currently stable at slightly above 2%.

Greece (EFSF)

For the EFSF Greek programme, the dynamics were different. Initially, Greece was mainly financed by disbursements in kind, with 87% of the initial disbursements indexed to the six-month Euribor rate. Therefore, the rates started relatively low and gradually moved upwards through November 2012. This occurred as the loans related to the private sector involvement, initially disbursed in kind, were rolled into the pool, and new pool-funded loans were disbursed. The Eurogroup decided in late 2012 to lighten Greece's repayment burden. It deferred Greece's interest payment until December 2022 and cancelled the initial guarantee commission fees of 10 basis points. The rates also remained significantly lower than those of Ireland and Portugal, mostly due to the funding structure: some loans for bank recapitalisation to Greece continued to be financed in kind whereas loans to Ireland and Portugal were only pool funded through longer duration fixed-rate funding instruments. Starting from January 2013, the upward rate movement stems from the rollover of the back-to-back loans to the pool. In 2014 and 2015, the lending rates for Greece remained relatively stable, in line with minor movements in the cost of the EFSF funding rate (Figure 25).

Figure 26: ESM historical blended lending rates



Note: Greek rates reflect interest rate payments, although these have been deferred.
Source: ESM

Spain (ESM)

Spain has also taken advantage of the low ESM lending rates, which have stabilised below 1%.

Initially, when it started operations, the ESM absorbed the EFSF bills programme and only provided financing on a short-term basis. The ESM thus granted the first loans through disbursements using short-term maturities designed to boost banks' capital and cover resolution costs. This explains why Spain obtained such low rates at the beginning of its programme. From the end of 2013, the ESM started issuing longer-term funding instruments, which, together with the rollover to the pool of loans initially disbursed in kind, explains the increase in the Spanish lending rate. After this increase, the rate remained constant in 2014 and 2015, with only minor movements in the cost of funding due to ESM funding activity (Figure 26).

Cyprus (ESM)

Bank recapitalisation disbursements lowered initial rates. Current rates have stabilised at below 1%.

Until September 2013, the ESM relied principally on pool-funded loans to finance the programme for Cyprus. For the same period, all Spanish loans were provided instead as in kind loans of ESM-issued notes. Thus, for the period before September 2013, there was a gap in funding rates between Cyprus and Spain because the pool-funded rates (cost of funding) were higher than the in-kind rates. After the disbursement in kind of the bank recapitalisation loan, Cypriot rates responded to the lower cost by falling 20 basis points. In 2014 and 2015, the lending rates of the two countries started converging. They also both increased as the ESM issued longer-term funding instruments, more pool-funded Cypriot loans were disbursed, and a large amount of Spanish and Cypriot loans disbursed in kind gradually shifted to the higher rate pool-funded loans (Figure 26).

Greece (ESM)

In August 2015, a new ESM-financed assistance programme for Greece began. Most of the new disbursements to Greece were made in cash; these were therefore pool funded and are priced on the basis of ESM's cost of funding rates. Other disbursements were made in kind, i.e. through issuance of ESM notes to recapitalise Greek banks. These in-kind debt instruments, whose price is based on the cheaper Euribor 6-month rate, can more swiftly be deployed to reinforce banks' capital (Figure 26).

FUNDING ACTIVITIES

- **New Greek programme sharply increases ESM's 2015 funding target and prompts big extension in ESM yield curve**
- **EFSF finishes full-year issuance target in first half**
- **ESM bill programme successful despite negative yield environment**
- **Longer maturity issues attract new investor categories**

Despite challenging financial market conditions, the ESM successfully carried out a larger-than-expected funding programme in 2015. Its forerunner the EFSF also negotiated the difficult environment well, wrapping up its full-year funding target in May. In this environment, it was as important as ever for the EFSF and ESM to stick to their government-style issuance pattern. They offered investors a transparent, predictable funding programme, delivering large liquid benchmarks across the curve.

Declining and negative yields at the short-end of the curve and talk of reduced market liquidity posed challenges for even high-quality Supranational, Sovereign and Agency (SSA), issuers like the ESM.

The European Central Bank (ECB) engaged in purchases of euro area government and agency debt in its expanded asset purchase programme. This increased demand led to increasingly lower, even negative, yields at the shorter end of the curve. As a result, SSA sector bond yield spreads narrowed against government bonds. The diminished yield dampened investor appetite for the sector although demand for ESM and EFSF issuances remained solid. As this environment particularly affected euro issuance, those issuers who could opted to issue in other currencies.

After many years of moving in tandem, the euro area and U.S. economies started to diverge as did the ECB's and the U.S. Federal Reserve's monetary policies. The Federal Reserve began to tighten, while the ECB eased further. Short-term dollar yields rose in response. Short-term euro yields broke repeatedly through their all-time negative lows.

The month of August saw the Chinese government intervene to try and shore up its domestic equity market. For this purpose, it made use of its foreign exchange reserves, with knock-on effects on the primary and secondary euro SSA market.

Market participants also often referred to deteriorated liquidity conditions in secondary markets. They noted that dealers appeared less willing than in the past to quote the prices and sizes that investors were used to.

Simultaneously, prices of oil and commodities collapsed. Oil-producing nations and, in particular, their sovereign wealth funds, were therefore less active in the bond markets.

New Greek programme sharply boosts ESM's 2015 funding target

The ESM originally announced that it would raise €14 billion in long-term funding in 2015, but the large new Greek programme pushed that target sharply higher and, finally, €23.5 billion were raised. That figure could have been higher yet. Spain, however, chose again in 2015 to voluntarily repay some of its obligations to the ESM early, initially reducing the 2015 target by €4 billion.

In August, euro area Member States agreed a new three-year financial assistance programme of up to €86 billion for Greece. Since the International Monetary Fund had yet to decide whether to participate in this programme, the ESM was the programme's sole 2015 funding source.

In the first half of the year, before the Greek deal was reached, the Spanish government offered to make two voluntary debt prepayments totalling €4 billion, cutting the ESM's initial funding by that amount to €10 billion. The ESM Board of Directors agreed first to a March prepayment of €1.5 billion, then to a further July repayment of €2.5 billion. Together, those payments initially reduced the ESM's funding needs to €10 billion. Spain, having successfully concluded a banking recapitalisation programme with the ESM in 2013, made its first voluntary prepayment in 2014.

The Greek deal required a nimble reaction from the ESM. It not only ratcheted up the overall long-term funding objective, but it also increased, for example, bill programme targets. The bill programme was successfully increased to €2.5 billion from €1.5 billion per auction. The ESM used these short-end issues to fund disbursements to Greece temporarily.

The programme also triggered a substantial lengthening of the ESM's maturity profile. Before the latest Greek programme, the ESM had engaged in two financial assistance programmes with Spain and Cyprus. ESM's funding activities focused on debt with maturities of up to 10 years, reflecting the length of the loans to those countries. The loans to Greece run substantially longer, to 2059, and have an average maturity of 32.5 years. These longer maturities follow the pattern of the second programme to Greece, provided by the EFSF. As a consequence of the new Greek programme, the ESM is now free to issue much longer-dated bonds. The Board of Directors amended the borrowing guidelines to allow it to issue up to the maximum maturity of outstanding loans. The new guidelines put the maximum issue limit at 45 years.

The ESM funding programme accommodated these changes smoothly. Its diversified funding strategy and bill programme afford it maximum flexibility in achieving its funding aim, a crucial advantage given the ESM's mandate. Under a diversified funding strategy, the funds raised are not attributed to a particular country. They are pooled and then disbursed to programme countries upon request.

Greek programme prompts big extension in ESM yield curve

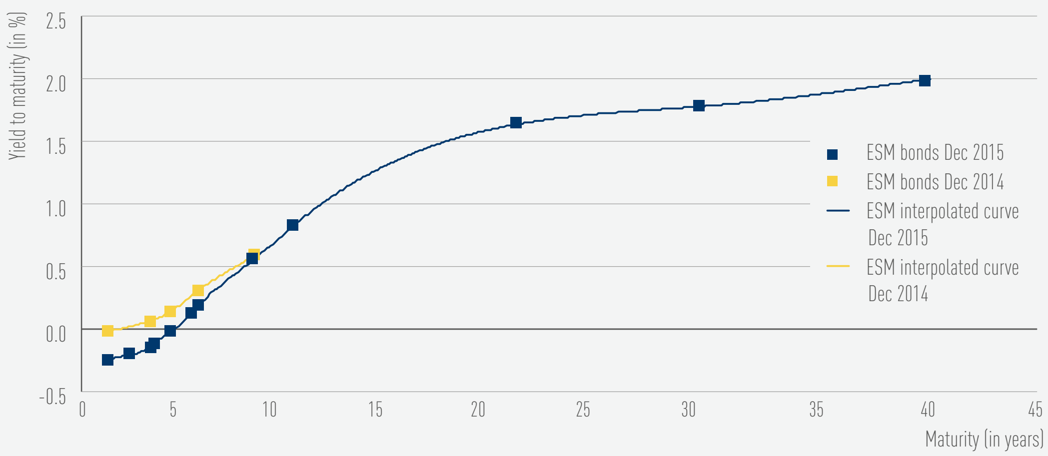
The revised funding targets also triggered a change in how the ESM raises those funds over the year. In the first half of the year, before the latest Greek programme was agreed, the ESM raised €5 billion. In March, it issued the first SSA benchmark with a negative yield, locking in favourable borrowing rates that it can pass on to programme countries. It raised €3 billion through this 2.5-year bond issue. An additional €2 billion came in July with the tap of an outstanding 5-year bond.

Once the additional funding requirements for the Greek programme became clear, the ESM returned to the bond markets in early September with a heavy funding schedule. Between then and the year end, the ESM issued six bonds for a total €18.5 billion. It substantially extended its yield curve, laying down fresh markers at the 10-, 21-, 30-, and 40-year points.

The ESM therefore ended the year with a full presence across the yield curve and increased the average funding maturity to 4.7 years at end December 2015 from 2.8 a year earlier.

2015 TRANSACTION HIGHLIGHTS

Figure 27: Interpolated ESM curve



Note: Data as of 31 December 2015.
Source: Bloomberg

ESM 2.5-year negative yield bond

On 10 March, the ESM placed its first 2.5 year bond. The transaction was priced with a -0.07% reoffer yield making it the first ESM bond to be issued with a negative yield. It was also the first syndicated euro-denominated benchmark bond issued at a negative yield within the SSA universe. Despite the negative return, the bond attracted very strong demand with over €9 billion in orders received from investors worldwide. The deal raised €3 billion for the ESM.

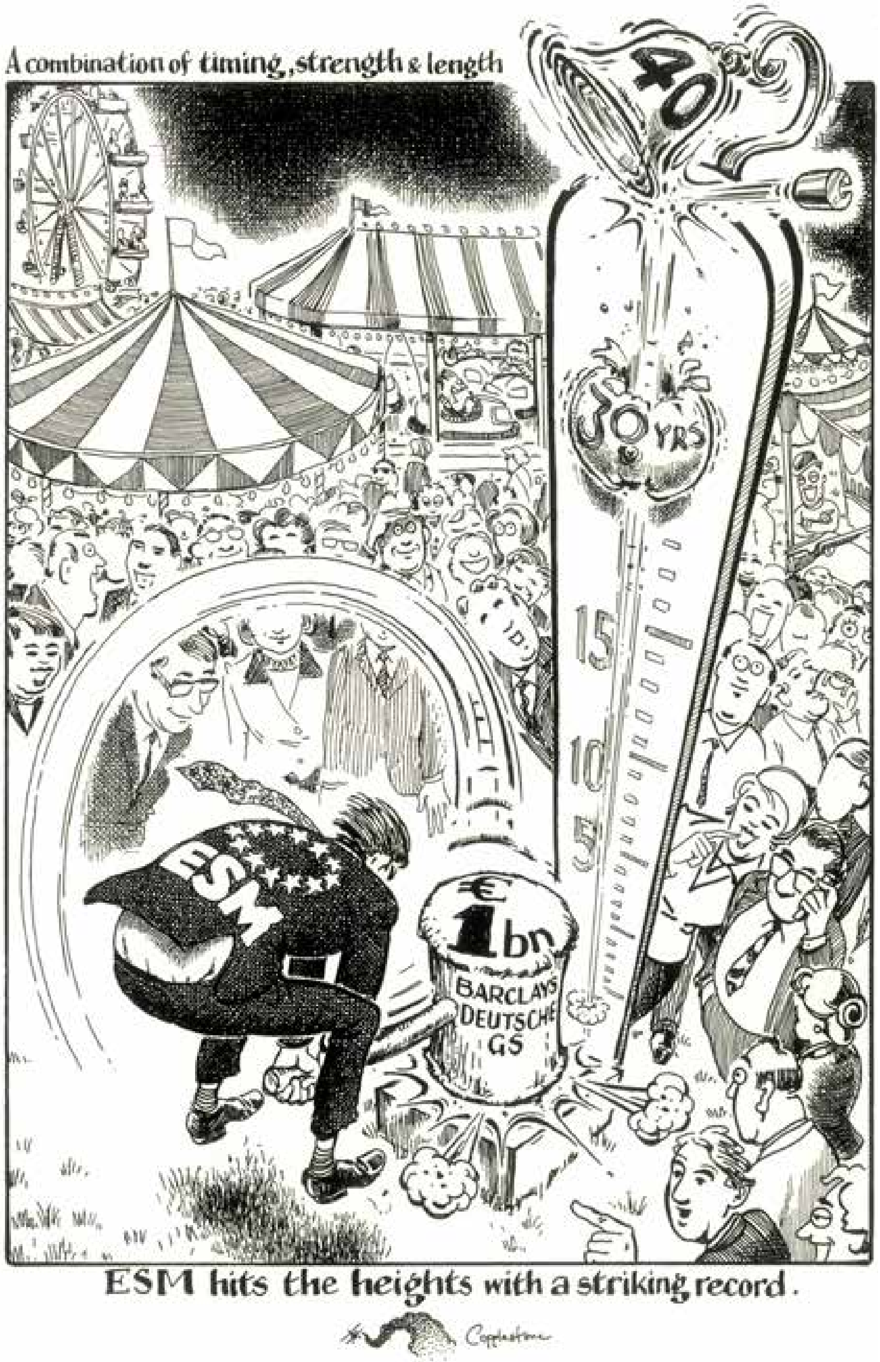
ESM's first 30-year bond

On 13 October, in line with the institution's objective to lengthen its maturity profile, the ESM priced its first 30-year bond. With a reoffer yield of 1.785%, this bond attracted new investors to the ESM, particularly European asset managers, insurance companies, and pension funds.

The ESM raised €3 billion – a significant size for a bond of this maturity and one that ensures liquidity in the secondary market.

ESM 40-year bond

On 24 November, the ESM placed a 40-year bond. While only €500 million was required to complete the funding programme for 2015, strong investor appetite meant €1 billion was raised. The ESM therefore pre-funded €500 million for 2016. The issuance of such a long maturity allowed the ESM to increase the duration of its portfolio and lock in the current low interest rates, the benefits of which will be passed on to the ESM's beneficiary Member States.



This cartoon marks the 24 November 2015 ESM issue of a new €1 billion 40-year benchmark bond, the longest maturity issued to date by the ESM or the EFSF. (Credit: Olly Copplestone)

ESM RESEARCH

Bond correlations show markets believe in ESM and EFSF

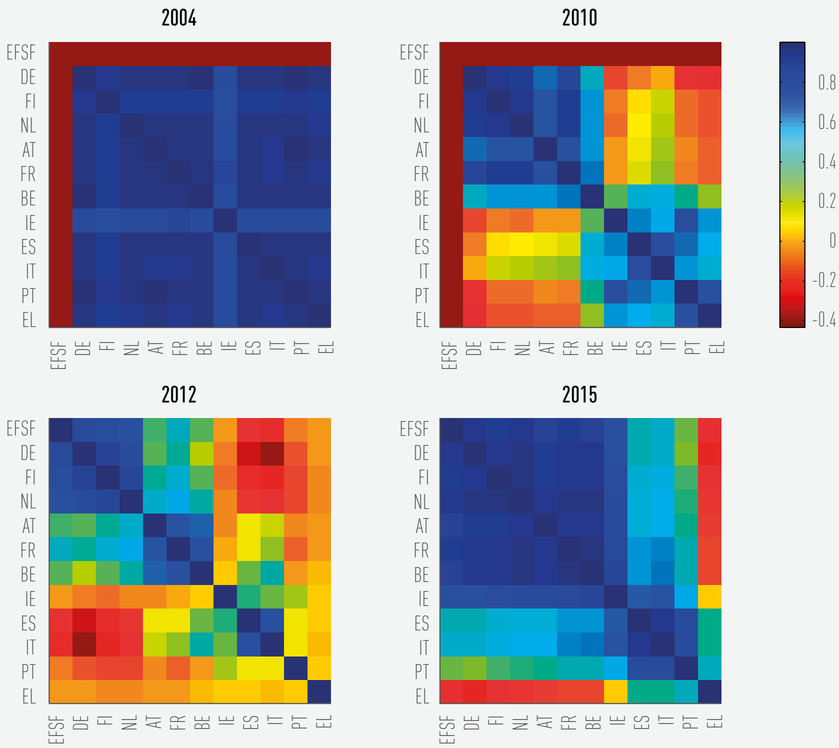
Market returns, or yield, can shed remarkable light on the thinking of investors. Comparing returns across markets provides insight, for example, into how investors perceive, evaluate, and rank the risks of investing in different markets. To discover the impact of Europe's new rescue funds on investor perceptions, ESM researched the relative yield movements across the various European sovereign bond markets before, during, and after the recent economic and financial crisis.

The research found that during the peak of the euro crisis, investors segmented the euro area into stable core and riskier periphery countries. But, from its establishment in 2010, investors gained confidence in the EFSF's guarantee structure. They recognised the EFSF as an issuer that was as stable as a core country. And that, together with the stabilising effect of the rescue programmes, helped to reconnect the peripheral countries to the core.

Have the EFSF and ESM changed how bond investors perceive the risks of investing in different countries' sovereign bonds?

ESM research finds that they have.

Figure 28: Correlation patterns among euro area sovereign bond yields



Note: The darker the blue the more in sync the price movements are; the brighter they are, the more they diverge.
Source: ESM

At the height of the crisis, a two-tier bloc of countries emerges: the core is seen as stable, the periphery as risky.

Specifically, the research looked at the development of bond yield correlations (Figure 28). It found that market perceptions moved through different phases. Initially, before the crisis (e.g. 2004) and in its early phases, there were many years with strong positive euro-area-wide correlations. At the height of the crisis, from 2010 to 2012, a two-tier bloc emerged. Investors treated a core bloc of Germany, France, the Netherlands, Austria, and Finland as less risky than a periphery bloc of Ireland, Greece, Spain, Italy, and Portugal.

The EFSF and ESM soon make their presence known, improving investor perceptions of the periphery.

The first EFSF 10-year bond, issued in June 2011, developed a correlation pattern similar to that of the core countries. In 2012, the year the ESM was established, rating downgrades subdivided the core, creating a sub-bloc of Belgium, France, and Austria. By 2013 and 2014, the impact of the European stability framework, with the two rescue funds as key players, was, however, palpable. Investor views of the core and periphery blocs stopped diverging, although uncertainty about the prolongation of the Greek programme was reflected in negative correlations between Greece and the core bloc in 2015. The other four countries under a rescue programme continued to re-attach to the core.

Bond investors' strategies make the rescue 'twins' behave rather like sovereign issuers.

An in-depth understanding of the dependency structure of the euro area sovereign yields is also of importance for investors: stable statistical dependencies allow for stable risk reduction in a euro area bond portfolio, including EFSF bonds. European bond traders confirm that EFSF and ESM bonds are used for strategies that seek to take advantage of mispricing of similar assets, or relative-value strategies. This is unusual for supranational issuers, and makes the European rescue 'twins', the EFSF and ESM, look and behave rather like sovereign issuers.

For more information, see the Working Paper: Schwendner, P., Schuele, M., Ott, T., Hillebrand, M. (2015) 'European Government Bond Dynamics and Stability Prices: Taming Contagion Risks', which is available on the ESM website at www.esm.europa.eu.

EFSF achieves 2015 full-year funding target by end of May

In contrast to the ESM, the EFSF was much more active in the first months of the year (Figure 29). It completed its final funding target of €12.5 billion by the end of May. Like the ESM, the EFSF issued across the yield curve. Its issues ranged from a 2-year bond in May to a 30-year bond first placed in February and subsequently reopened in May.

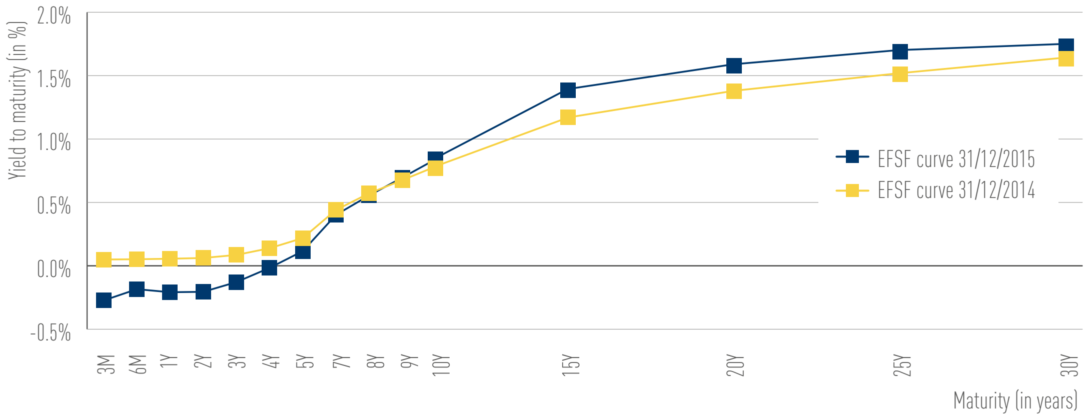
The EFSF cut its original funding target of €13.5 billion by €1 billion. The EFSF programme for Greece, the second programme, expired without the final disbursement being made. The EFSF therefore cancelled the €1 billion scheduled to be raised in the fourth quarter and reduced the EFSF funding target by that amount.

Over the year, the EFSF yield curve steepened. The combination of the ECB deposit cut and its public sector purchase programme moved short- to medium-term yields into negative territory. Prospects for future euro area growth and the market belief that inflation rates would return close to the ECB's inflation aim of below, but close to, 2% caused longer-end yields to rise.

EFSF bonds outperform ESM bonds in 2015

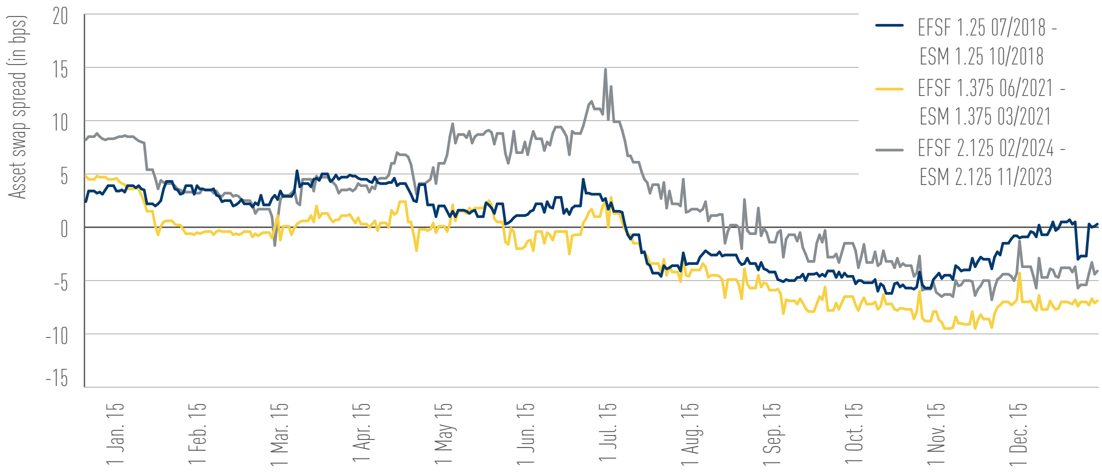
EFSF bonds outperformed ESM bonds in 2015, posting tighter spreads and yields, reversing past performance (Figure 30). The EFSF's early completion of its funding programme and the sharp rise in the ESM's funding requirement drove the EFSF's outperformance. The resulting scarcity value around the EFSF name also contributed.

Figure 29: Interpolated EFSF curve



Note: Data as of 31 December 2015.
Source: Bloomberg

Figure 30: Asset-swap spread difference between EFSF and ESM bonds



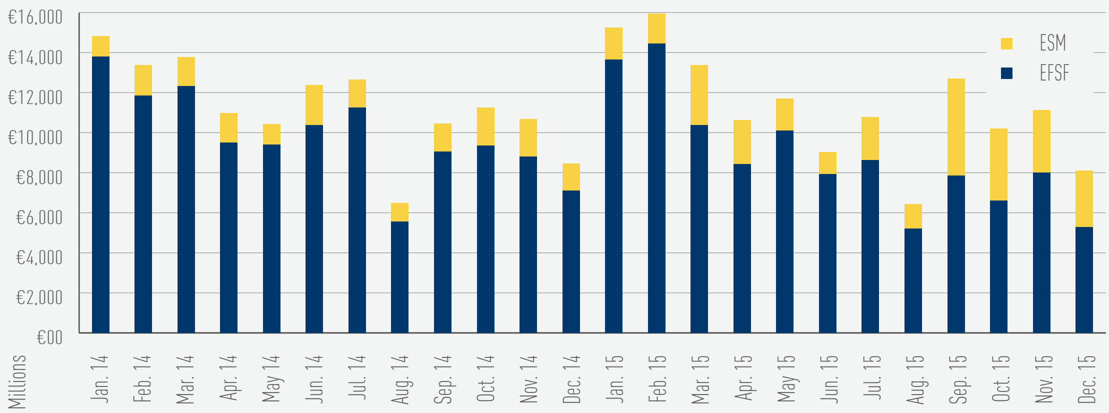
Note: Data as of 31 December 2015.
Source: Bloomberg

ESM/EFSF BOND TRADING RESISTS MARKET LIQUIDITY FEARS

Overall EFSF and ESM bond turnover stable in 2015, ESM rise compensates for EFSF decline.

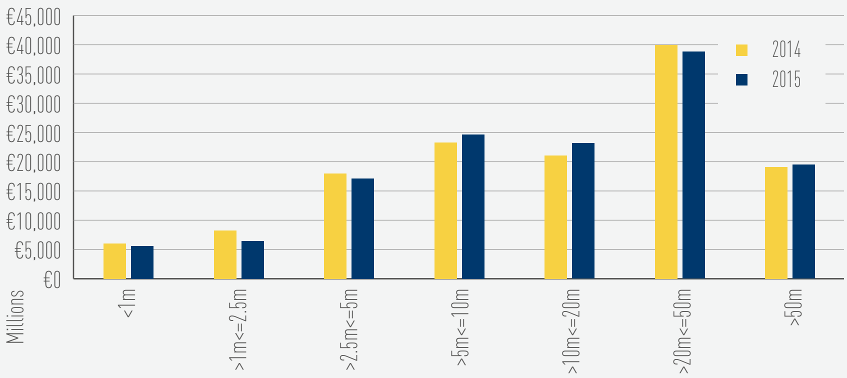
Total turnover of EFSF and ESM bonds remained stable in 2015, despite market concerns of decreased secondary market liquidity (Figures 31, 32 and 33). A rise in ESM bond turnover, given additional supply in the second half of the year, compensated for a decline in trade in EFSF issues, as the latter was less active on the primary market.

Figure 31: Monthly turnover volume – EFSF and ESM bonds excluding public sector purchase programme



Source: ESM

Figure 32: Turnover volume per ticket size bracket excluding public sector purchase programme – EFSF and ESM bonds

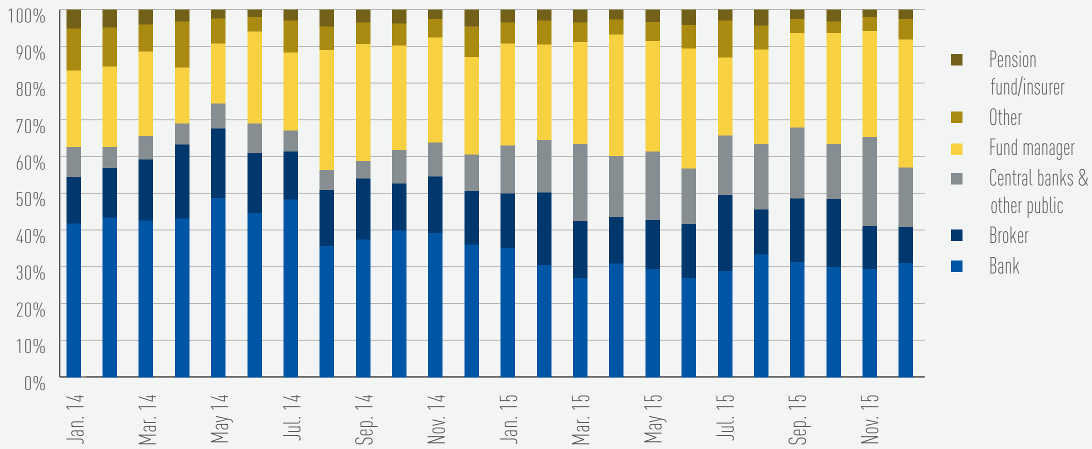


Source: ESM

The average size of trades also remained little changed for both the ESM and EFSF. Both have good turnover in trades of more than €10 billion, indicating solid secondary market liquidity. Both issuers have a well-diversified and stable investor base in the secondary as well as the primary markets.

Average trade size remains healthy for both – the sign of a stable, diversified investor base.

Figure 33: Turnover share per customer – EFSF and ESM bonds excluding public sector purchase programme



Source: ESM

ESM raises €41.7 billion in 2015 bill programme, all at negative yields

The ESM issued €41.7 billion in its regular 3- and 6-month bill auctions in 2015, all at negative yields. Negative yields lower the ESM's overall funding cost, which the ESM then translates into reduced borrowing rates for beneficiary Member States.

The declining and historically negative yields weakened investor demand for the SSA sector. Nevertheless, demand for ESM paper remained robust. Auctions were well-subscribed. The ratio of bids to available bonds, a gauge of demand, reached on average 2.4 for 3-month, and 1.9 for 6-month, bills in 2015.

The 2015 ESM issuance slightly outstripped its 2014 total of €38.5 billion. The ESM ended 2015 with more than €18.2 billion outstanding, which it will roll into long-term funding in 2016.

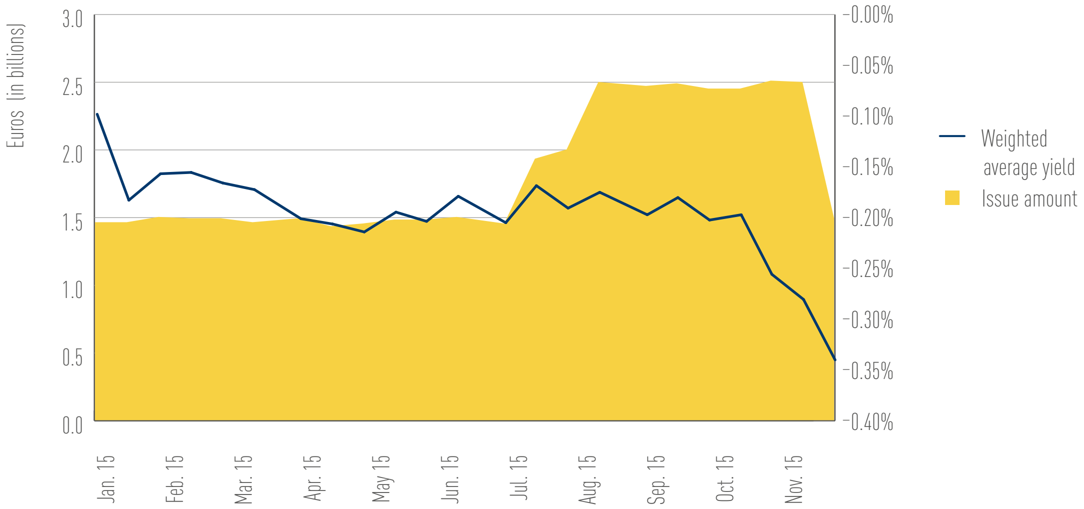
The bill programme helped the ESM to fund the initial disbursements of the new programme to Greece. It prevented oversupply at the long end, thus again proving its value as an effective and flexible tool to manage liquidity.

ESM's longer maturities attract new investor groups

The new, longer ESM maturities addressed long-end investors for the first time. Insurance companies and pension funds, which seek to match their long-term obligations with similarly lengthy income streams, increased their participation by 6% in 2015. Likewise, asset managers boosted their ESM investments by 19% as they privileged long-term investments. In contrast, participation from central banks and bank treasuries, investors who focus more on the shorter-term, decreased.

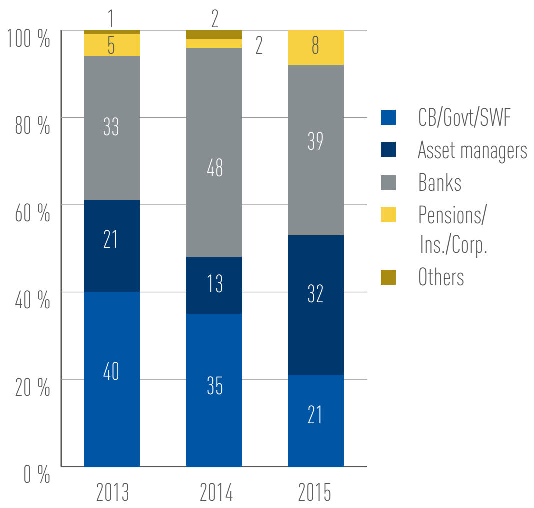
Interest from Asia, home to many large central banks, also fell as a result. The euro area, the United Kingdom, and Sweden – where many asset managers are based – grew more active (Figures 35 and 36).

Figure 34: ESM bill auctions 2015



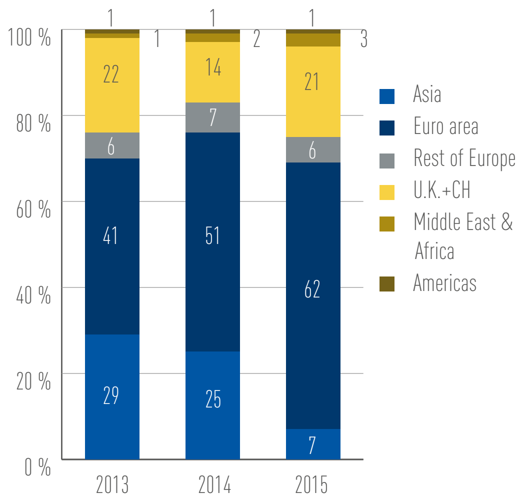
Note: Data as of 1 December 2015.
Source: ESM

Figure 35: ESM investor breakdown, by investor type



Source: ESM

Figure 36: ESM investor breakdown, by geographic location



Source: ESM

ESM RESEARCH

Disentangling fundamentals from opinion in credit rating agencies' euro area sovereign ratings

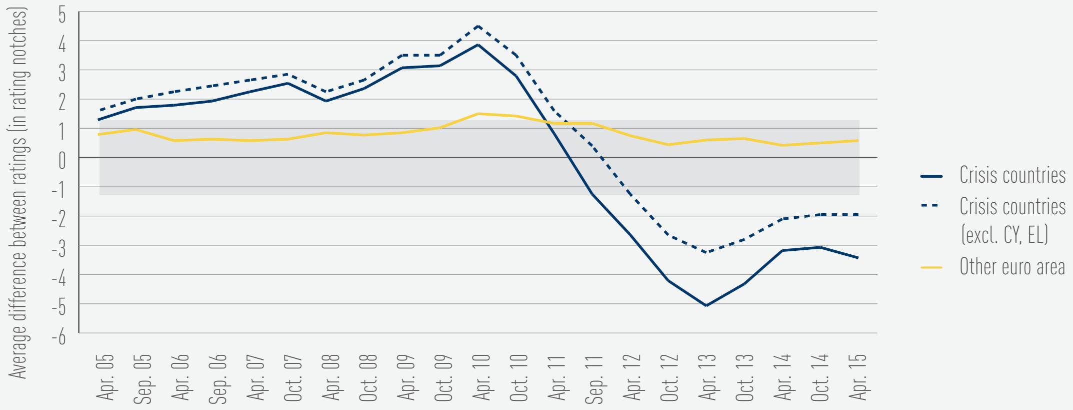
Credit rating agencies assign a sovereign rating on a country after critically assessing the central government's ability and willingness to pay back its commercial debt in full and on time. They combine their analysis of fundamental facts with expert, but nonetheless subjective, judgements. ESM research shows that in determining their ratings, agencies may apply judgement to varying degrees, both across countries and over time. Given the ratings' systemic relevance, these decisions could have costly consequences for both policy makers and investors. For the ESM, this research confirms that rating agency assessments do not always accurately reflect a sovereign's fundamentals (Figure 37).

ESM research finds that ratings by credit rating agencies (CRAs) do not always reflect a sovereign's fundamentals.

Specifically, the ESM study examines sovereign ratings for the 19 euro area Member States from 2005 to 2015. It reveals that the credit rating agencies have applied the subjective component to varying degrees across countries and over time. It finds that the scorecard-derived fundamental rating diverges, sometimes quite significantly in terms of rating notches, from the actual rating. For some countries, this deviation was positive before the crisis, negative during the crisis and remains negative after the crisis. Other countries appear to have benefited from more benign subjective views. For yet another group, the ratings were broadly in line with fundamentals over the entire 10-year period.

In addition to quantitative elements, CRAs apply their judgement in assigning sovereign ratings.

Figure 37: Difference in actual vs. 'fundamental' rating



Note: The grey area refers to the +/- 1 notch range of the 'fundamental' rating.
Source: ESM calculations. Crisis countries: IE, EL, ES, IT, CY, PT, and SI

Judgement is applied to varying degrees across countries and over time.

The analysis further reveals that the subjective rating component can be explained by past decisions as well as market sentiment, which is measured by the gap between the return on a country's 10-year government bond compared to Germany's 10-year Bund, the traditional benchmark. This gap fluctuates, typically expanding as market concerns focus on a country and narrowing again as those worries are put to rest.

Using internal judgement is legitimate but CRAs should increase transparency.

This study does not suggest that credit rating agencies should dispense with this subjective component. Quite the opposite. Given the shortcomings of any model, agencies are right not to rely mechanistically on their models' output. There is nothing wrong in using subjective judgement to arrive at an assessment of a sovereign's creditworthiness. The results suggest, however, that credit rating agencies should be more transparent in divulging the extent to which models or opinions drive their rating outcomes.

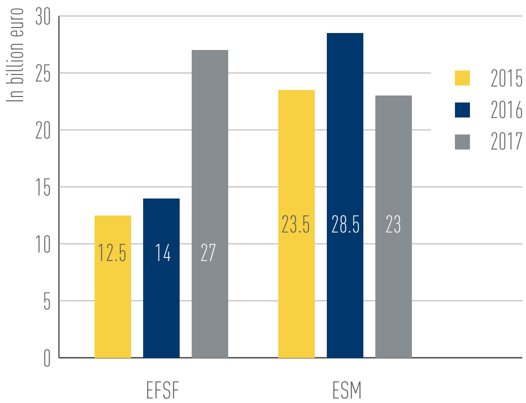
ESM research suggests that agencies could publish two ratings, one quantitative, based on fully specified methodologies, and another including their judgement.

Indeed, credit rating agencies could publish two ratings. One would be derived purely quantitatively. It would reflect publicly available data on macroeconomic, institutional and public finance fundamentals and, combined with fully transparent methodologies, would allow policymakers and market participants to determine each agency's fundamental rating themselves. The second rating would include agencies' judgements and opinions which policymakers and market participants may or may not agree with.

For those wishing information on the methodology used or more detail on the results, see the Working Paper: D'Agostino, A., Lennkh, R. A. (2016) 'Euro Area Sovereign Ratings: An Analysis of Fundamental Criteria and Subjective Judgement', which is available on the ESM website at www.esm.europa.eu.

ESM, EFSF set 2016 funding targets at €42.5 billion total

Figure 38: ESM and EFSF expected funding programmes 2015-2017



Note: The ESM and EFSF funding targets are based on forecasts as of 31 December 2015 and are subject to change.
Source: ESM

The ESM's 2016 long-term funding target was initially set at €28.5 billion. These funds will be used to continue financing the programmes for Cyprus and Greece and also to roll over existing maturities.

Following the expiry of the Cypriot programme in March 2016, the remaining €2.67 billion from the programme was not disbursed. The ESM funding target for 2016 was subsequently revised downwards to €25.5 billion.

The EFSF's 2016 long-term funding target was set at €14 billion. The EFSF no longer has to fund any disbursements to beneficiary Member States, but it continues to fund the rollover of existing maturities.

Therefore, the combined long-term funding for the two issuers in 2016 will be €39.5 billion (Figure 38).

ESM introduces German-registered N-Bonds

The ESM announced in December that it would begin in 2016 to issue certain registered bonds under German law issued in private placements. The N-Bonds, or Namensschuldverschreibungen, will enhance the structure of the ESM's debt portfolio. They will also further diversify the investor base by offering a new investment possibility, mainly for long-term investors.

ESM receives recognition as issuer

Representatives of the funding team, including Head of Funding Siegfried Ruhl (right), accept the GlobalCapital awards.
(Credit: GlobalCapital/Gerald Hayes)

In September 2015, the Bank of England added ESM and EFSF securities to the list of international institutions eligible as a type of collateral for its Money Market operations, underscoring once again the solidity of the rescue funds' issues.

The ESM received a number of industry awards in 2015, testimony to its successful funding strategy over the year.

In May, at the Global Capital Bond Awards, the ESM received three awards: 'Overall Most Impressive SSA Funding Team'; 'Most Impressive Supranational Funding Team Overall'; and the ESM's Head of Funding, Siegfried Ruhl, was designated the 'Most Impressive Supranational Funding Official in €'.

In December, the International Financing Review named the ESM the SSAR Issuer of the Year.

MAJOR RATING AGENCIES AFFIRM ESM'S HIGH CREDIT RATINGS

The ESM ranked among the international financial institutions with the highest creditworthiness throughout 2015. The major rating agencies affirmed the ESM's ratings in 2015, keeping them at the same high levels as in previous years. They retained their positive assessments after the ESM disbursed loans to Greece in 2015, which prompted an expansion in the organisation's balance sheet. The ratings are shown in the following table.

ESM's high creditworthiness derives from euro area Member States' commitments and its own intrinsic strengths.

The ESM's high creditworthiness derives from euro area Member States' commitment and ability to support the institution as well as its intrinsic credit strengths. The following key elements underpin the ESM's credit ratings:

- ESM's €80 billion in paid-in capital and its low leverage, which compares favourably to its peers;
- the creditworthiness of ESM's shareholders, the euro area Member States, which subscribed callable capital. A unique capital call mechanism allows the ESM's Managing Director to call capital to avoid a default on maturing debt, without requiring approval from the ESM's decision-making bodies;
- ESM's continued ability to create and retain revenues on its balance sheet;
- strong investment management policy, prudent risk management guidelines, and an Early Warning System ensure that funds are available on time to pay debt obligations; and
- the ESM's preferred creditor status, junior only to the IMF.

Table 5: ESM credit ratings, as of 31 December 2015

FITCH			MOODY'S			DBRS		
Long-term rating	Short-term rating	Rating outlook	Long-term rating	Short-term rating	Rating outlook	Long-term rating	Short-term rating	Rating outlook
AAA	F1+	Stable	Aa1	P-1	Stable	AAA	R-1 (high)	Stable

Note: ESM ratings by DBRS are unsolicited.
Sources: The rating agencies named, compiled by ESM

INVESTMENT AND TREASURY

- **ESM realises income of €578 million on paid-in capital portfolios**
- **Latvia and Lithuania pay in capital**
- **ESM enlarges investment universe**

The ESM manages, prudently and conservatively, €80.15 billion of capital paid in by the euro area Member States. The paid-in capital contributes to ensuring the institution's creditworthiness, an essential factor supporting the ESM's capacity to borrow on financial markets at favourable rates.

In 2015, the value of the paid-in capital continued to increase, in part because new members continue to pay in capital. Also, as European yields fell, in particular at the front end of the yield curve, the price of fixed income assets rose. German 2-year yields fell below -0.40% and the 5-year, below -0.20%, reflecting the ECB moves to expand its accommodative monetary policy. This downward move in yields, and the resulting appreciation in bond prices, more than offset the impact of the negative running yields on the portfolio. Consequently, the ESM delivered a positive performance on the year and realised, in accounting terms, €578 million in income. This income will help the ESM achieve its goal of long-term capital preservation.

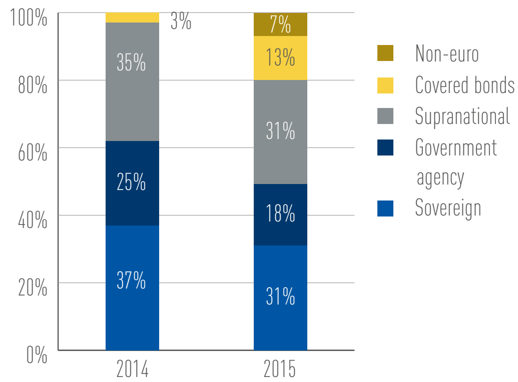
As short-term yields slid steadily deeper into negative territory, some investors, aiming to capture higher yields, opted to extend the average maturity of their investments, which automatically increases their portfolios' sensitivity to interest rate fluctuations. In contrast, the ESM maintained a conservative approach. It chose to contain its overall interest rate risk, in an environment characterised by high interest rate volatility (the benchmark German 10-year Bund yield swung in an exceptionally wide 90/95 basis point range between April and June 2015).

To improve the overall return of its portfolios, the ESM tried consistently throughout the year to take advantage of the additional return offered by some highly rated eligible issuers such as public agencies, supranational entities as well as by some covered bonds. The ECB's Asset Purchase Programme and investors' search for assets with positive yields supported the value of these assets.

Latvia and Lithuania make paid-in capital instalments

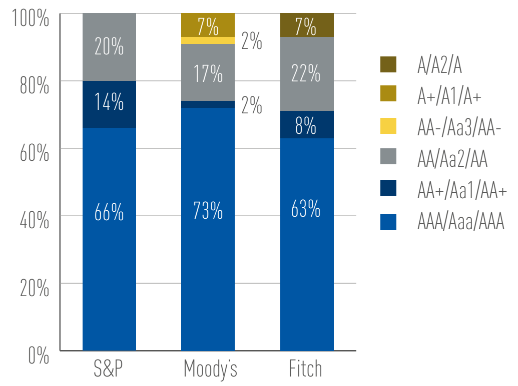
Latvia, which joined the ESM in 2014, and Lithuania, which joined in 2015, will provide the ESM with an additional €548.4 million of paid-in capital, which will be paid over five years. In 2015, the ESM received the first annual instalment from Lithuania and the second from Latvia, which increased the paid-in capital by €109.68 million (Figures 39, 40 and 41).

Figure 39: Securities breakdown of ESM paid-in capital, by asset class



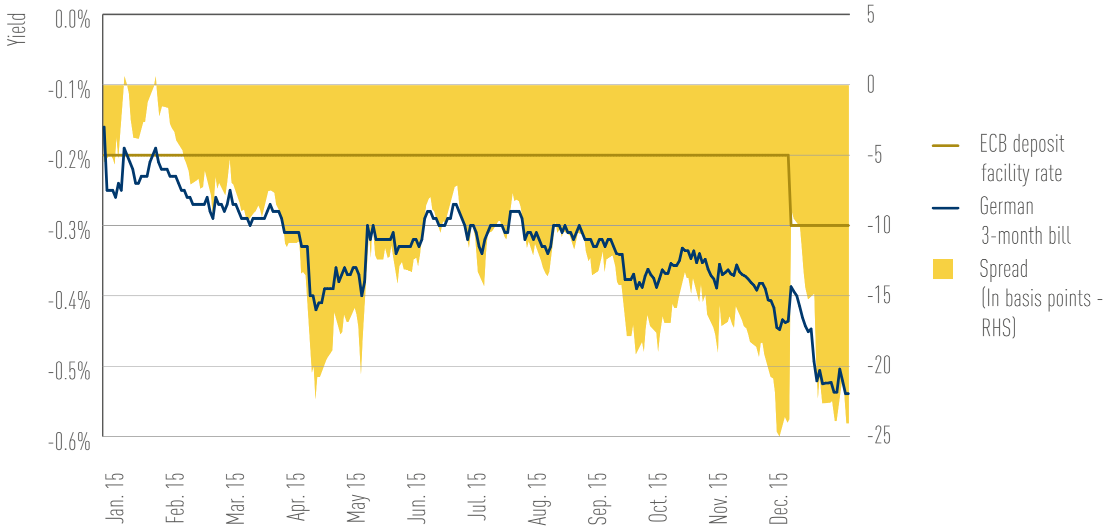
Note: Breakdown as of 31 December 2015.
Source: ESM

Figure 40: Rating distribution of the paid-in capital securities, by rating agency



Note: Distribution as of 31 December 2015.
Source: ESM

Figure 41: German 3-month T-bill and ECB deposit facility rate



Note: Data as of 31 December 2015.
Source: Bloomberg

ESM enlarges its investment universe

The ESM launched a series of measures to enlarge its investment universe and to increase its holdings in high-quality and liquid assets with more favourable expected returns. In particular, the ESM took three important steps during the year:

1. **Revision of the ESM Investment Guideline's annexes, by the Board of Directors**. These annexes define the type and the minimum rating of the assets the ESM can invest in. The objective was to enlarge the investment universe, without affecting the ESM's creditworthiness:

   - **The ESM General Eligible Asset List (GEAL)**, in which €75 billion of the paid-in capital must be invested, has been enlarged. The revisions introduce, in the GEAL, AAA covered bonds and AA to AAA issuer types such as government guaranteed, sub-sovereigns (regions and local states), and non-euro area government agencies.

   - **The ESM Enlarged Eligible Asset List (EEAL)**, in which the remaining part of the paid-in capital can be invested, has also been enlarged. The changes lower the minimum rating for all debt issuers to A from AA, except for securities issued by financial institutions, where a minimum rating of AA is still required.

2. **Introduction of non-euro instruments.** To increase the geographic diversification of the paid-in capital and to widen the investment universe, the ESM introduced non-euro instruments in maturities under one year. To hedge the currency risk that arises from purchasing assets denominated in a foreign currency, the ESM contracts simultaneously foreign currency exchange swaps, which enable it to offset the currency risk on all the cash flows and generate a synthetic euro exposure.

   The ESM can, from now on, conduct operations in nine major non-euro currencies: the Australian dollar, the British pound, the Canadian dollar, the Danish krona, the Japanese Yen, the Norwegian krona, the Swedish krona, the Swiss franc, and the US dollar. It has started investing in currencies offering the most favourable returns, after taking into account the cost of hedging the foreign exchange risk. By year-end 2015, the ESM had invested some 3 % of the paid-in capital in Japanese yen and Danish krona.

3. **Increase in the number of eligible issuers**. To further diversify among issuers and decrease concentration risk, the ESM increased the number of eligible issuers to more than 80 from about 55 in 2015. In particular, the ESM has increased its ability to invest in AAA covered bonds issued in euros by financial institutions located outside the euro area.

The strategies implemented in 2015 have led to adjustments in the paid-in capital's investment structure. As a portion of the portfolio is invested in more diversified assets – including non-euro assets and covered bonds – sovereign, government agencies, and supranational issuers now represent a smaller, though still sizeable, part of the portfolio. Their share has dropped to 80% of the invested assets from 97% in 2014. Simultaneously, as the yield on short-term liquid securities fell below the Eurosystem's deposit facility rate, the proportion of cash left with the Eurosystem progressively rose.

The changes in the portfolio structure have not affected the overall credit quality of the paid-in capital. The breakdown by rating remained almost unchanged. In particular, the share of assets rated AA/Aa2 and above has remained very high: 100% for S&P, 92% for Moody's, and 93% for Fitch.

HOW THE ESM MANAGES ITS INVESTMENT PORTFOLIOS IN A DECREASED LIQUIDITY ENVIRONMENT

Falling liquidity in European fixed income markets has raised concerns as it tends to reduce the size of trades that can be conducted without affecting market prices. For the ESM to have only a limited impact on market prices, a requirement stipulated in the ESM's Guideline on Investment Policy, the ESM has defined a special operational framework that covers all aspects of the investment process. It is based on three dimensions that drill down from an overarching strategy to daily portfolio monitoring and adjustment. First, it has a long-term investment strategy that does not require large-scale portfolio purchases and sales. Second, it diversifies assets, focusing on those with sufficient liquidity to reduce the impact of trades on any single issuer or security. Finally, it conducts transactions and calibrates them so that they can be absorbed, without difficulty, by market participants.

ESM investment strategy is prudent and aims to have limited market impact.

ESM's long-term investment strategy avoids large-scale portfolio rebalancing

- **ESM investment strategy focuses on long-term capital preservation.** The core structure of the portfolio remains relatively stable over time, as it is constructed to respect the ESM's long-term capital preservation objective. In practice, the paid-in capital, which is divided into a short-term tranche (mainly invested up to 3-years maturity) and a medium-long-term tranche (mainly invested up to 10-years maturity), has a capital preservation objective of one and three years, respectively.

ESM focuses on preserving capital and regularly adjusts the portfolio structure.

- **ESM reviews investment strategy regularly to ensure smooth adjustment over time**. As a result of the long-term investment objective, adjustments to portfolio risk parameters are implemented progressively to reflect changes in market conditions, such as yield levels, spread levels, and interest rate volatility. The ESM Investment Management Committee, which oversees the implementation of the ESM Guideline on Investment Policy, discusses these adjustments on a monthly basis, in light of medium-term macroeconomic and financial developments.

ESM diversifies assets, focuses on those with ample liquidity

ESM invests in liquid instruments spread across asset classes and investors.

- **ESM structures paid-in capital to assure a high level of available liquidity,** as it could, in exceptional circumstances, be needed. The short-term portfolio of the paid-in capital guarantees emergency liquidity to the ESM. This portfolio, which has a minimum size of €5 billion, can be increased in response to expected liquidity needs. It must be invested in the highest quality assets and respect higher liquidity constraints. More broadly, the ESM must ensure that the liquidity of the entire paid-in capital remains elevated with a large share invested in highly liquid instruments.

- **ESM diversifies paid-in capital widely to ensure only modest impact on any single issuer or security.** The ESM's Guideline on Investment Policy requires that a minimum of 30% of the assets be invested in non-euro area issuers or supranational entities. In addition, the paid-in capital is also diversified at the sector and issuer levels, with investments in governments, public agencies, government guaranteed entities, sub-governments, supranationals, central banks, and financial institutions, the latter for covered bonds only. Currently, the ESM invests in more than 80 issuers among these assets, with investments spread across the yield curve, allowing for a low concentration per issuer and security.

ESM calibrates transactions to reflect market depth and conducts them across various channels

ESM adapts its operations to variable market conditions.

- **ESM executes transactions taking into account market depth and liquidity.** The ESM conducts transactions based on a regular assessment of market structure, the selection of counterparties able to provide the required liquidity, and the market dynamics that might increase or reduce liquidity at times. To do so, the ESM has a dedicated team of investment specialists, with expertise in European fixed income markets, who perform daily transactions in the market and assess liquidity conditions. In 2015, the ESM allocated portfolio managers to market segments to enhance geographical specialisation: euro area AAA/AA+ countries and associated issuers; euro area AA/A countries and associated issuers; supranationals and non-euro area countries and associated issuers.

- **ESM implements transactions through a range of channels, enabling good access to market liquidity.** The ESM operates regularly in both the primary and secondary markets. Primary market operations, in particular, make it possible to purchase a large amount of a single security while minimising the impact on market prices. The introduction of derivative instruments should further increase the ESM's ability to adjust the investment portfolios' positions.

- **ESM conducts investment operations with a diversified group of eligible international counterparties.** In 2015, the ESM traded with over 30 counterparties specialised in the market segments where the ESM is present. The ESM regularly reviews pricing quality and the capacity to provide liquidity consistently to ensure that operations are efficiently conducted.

Investment strategy process

RISK AND COMPLIANCE

- **Risk and compliance management at the ESM is built on a relevant best practice framework, continuously adapted to new business requirements**
- **Risk management is a shared responsibility across the institution, through the three lines of defence model**
- **Maintenance of best practice in risk and compliance management is ensured by ongoing networking with peer institutions and subject matter experts**

As the ESM develops, its risk management needs to develop as well. To address evolving challenges, the Risk team undertakes an annual review of ESM's risk management policies, refines its compliance and operational risk framework, and develops risk methodologies to accommodate expanding operational capabilities. Risk and Compliance led the ESM's technical assistance project for Cyprus, which dealt with the methodology for assessing the credit risks of Cypriot government-guaranteed loans. It established close collaboration with other international institutions to exchange best practices and organised a risk management conference.

The ESM needs to maintain the highest creditworthiness to best fulfil its mandate. The Risk team supports this by maintaining a conservative and comprehensive risk and compliance framework appropriate for an intergovernmental institution that safeguards the stability of the euro area and euro area Member States.

During the year, the Risk team developed appropriate risk methodologies to accommodate the introduction of new instruments for debt issuance and capital investment. Specifically, it defined the potential risks arising from foreign currency transactions, repurchase agreements, and reverse repurchase agreements and reviewed the risk policies for that purpose.

The ESM has joined the ranks of peer international financial institutions (IFIs), and now actively participates in an annual IFI Operational Risk Forum, which was first established in 2008. In addition, the ESM organised and hosted the first meeting of an offshoot of this global forum, the European chapter, in 2015. These forums provide an excellent opportunity for the participating IFIs to exchange best practices across the industry – from identifying emerging operational risks to adapting risk management approaches in a continually changing environment – and benefits all involved.

The ESM co-sponsored a risk management conference focusing on how investments, financial stability, and regulation will shape European and global financial markets – and what that means for risk management. The conference brought together some 200 risk practitioners and academics from around the world to Luxembourg in June, with main organisers being the University of Florence and the Stern School of Business of the New York University.

In this photo, ESM Chief Risk Officer Cosimo Pacciani addresses the conference.

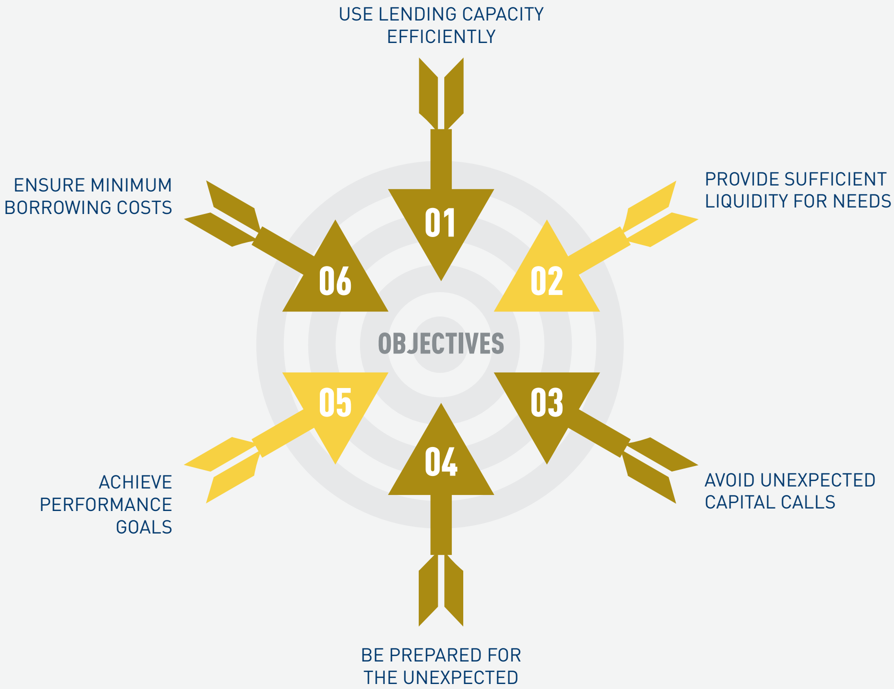
ESM ADHERES TO STRICT RISK MANAGEMENT FRAMEWORK

The ESM has defined clear risk management objectives and an established strategy to deliver them through appropriate governance and core risk management processes. The organisation's approach to risk management derives from the ESM Treaty and the 'High Level Principles for Risk Management', which in summary are to:

- follow a prudent approach to risk-taking to limit potential losses, ensure continuity in fulfilling the ESM's mandate and meeting its commitments, and avoid unexpected capital calls;
- maintain minimum capital requirements to ensure the highest creditworthiness;
- preserve the ESM's funding and, hence, lending capacity.

The ESM applies elements of its risk management framework to all aspects of its mandate. Some risks are accepted as part of the ESM Mandate. The primary example is counterparty risk on financial assistance the ESM grants to Members. The ESM aims at fully covering its financing and operating costs but not at generating profit on such financial assistance. Equally, it does not provide incentives for speculative exposures of its investment portfolio.

ESM risk management objectives



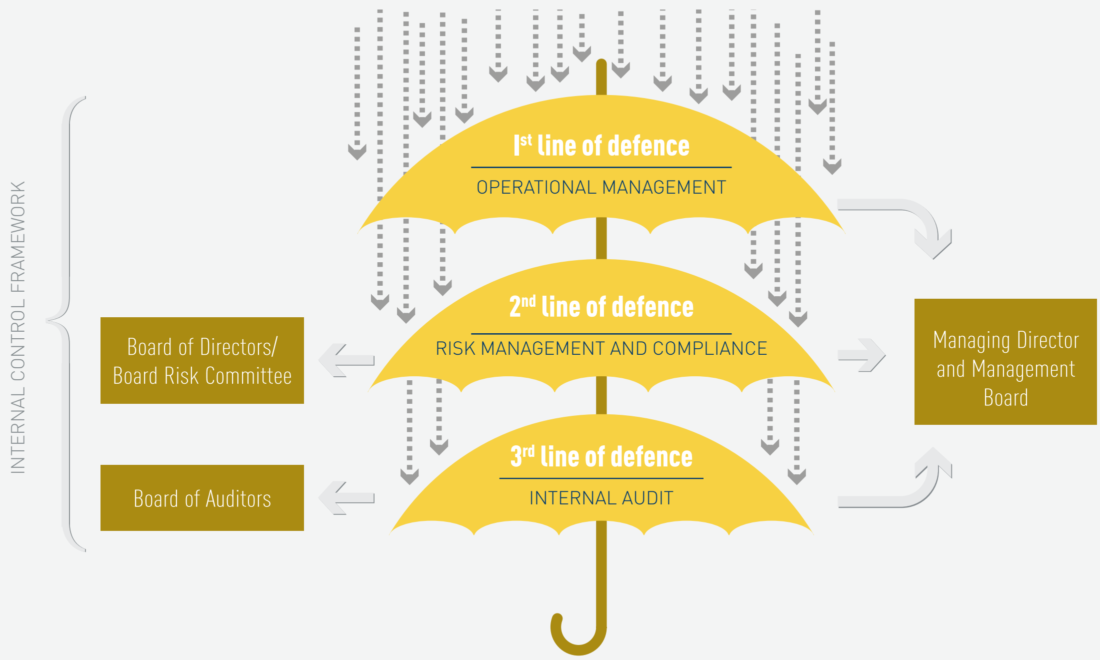
Risk governance

The Board of Directors is accountable for the adequacy of the ESM risk management framework, and the Managing Director for implementing it. The ESM has established two risk committees:

- the Board Risk Committee, a permanent committee of the Board of Directors, advising it on the overall current and future risk appetite, and assisting it in reviewing and overseeing the development of the ESM's risk management framework;
- the Internal Risk Committee, a permanent internal ESM committee, comprising the Management Board and Chief Risk Officer, which evaluates, monitors, and approves practices regarding the implementation of the ESM's risk management framework.

Risk management responsibilities within the ESM are established on the 'Three Lines of Defence' concept, which sets out clearly drawn lines of authority and appropriate segregation of powers and duties.

The three lines of defence model



The **first line of defence** consists of business functions and departments with direct responsibility for the day-to-day management of risk. The **second line of defence** is performed by an independent risk and compliance management function, led by the Chief Risk Officer, which oversees the risks assumed by the business and ensures they are appropriately managed and controlled. The **third line of defence** consists of an independent internal audit function, led by the Head of Internal Audit, responsible for providing the Board of Directors with assurance that risk management controls are operating properly and efficiently. Both the Chief Risk Officer and Internal Auditor report directly to the Managing Director, but also to the Board Risk Committee and Board of Auditors, respectively, to ensure their independence. The Board of Directors and the Board Risk Committee are kept informed and updated on the risk framework, and have expressed their satisfaction with ESM risk and compliance operations.

Risk appetite

The ESM Risk Policy documents the appetite for risk that the ESM Board of Directors is willing to accept in the execution of the organisation's mandate. The ESM management and Risk department cascade this risk appetite into relevant aspects of governance, policies, frameworks, and individual limits to ensure that the organisation's activities remain within it.

Risk culture

The strong risk culture at the ESM is founded on the nature of a risk function as an independent component of the institution, which in turn ensures rigorous challenge and objectivity in decision-making, in a context of shared awareness on risk matters across the institution. Risk culture is supported by the combined set of individual and corporate values, attitudes, competencies, and behaviours that determine the ESM's commitment to the management of risk at all levels. Supported by management, risk culture in the ESM is founded on a close alignment between the organisation's objectives and the risk management framework.

Risk management process

The ESM has implemented a systematic four-step process to manage the various types of financial and non-financial risk to which the organisation is exposed, as detailed in the following infographic.

Four-step management process

04 RISK MANAGEMENT

Process of determining and executing appropriate actions to actively manage risk exposures, such as mitigation, transfer, reduction, or acceptance of the risk.

03 RISK MONITORING AND CONTROL

On-going monitoring and control of material risk exposures, including limit frameworks, key risk indicators, reporting, and escalation.

02 RISK ASSESSMENT AND MEASUREMENT

Assessment of identified risk exposures to determine their materiality, based on a combination of quantitative tools and expert judgement.

01 RISK IDENTIFICATION

Identification of all material risk exposures, both financial (credit, market, and liquidity risk) and non-financial (reputational, legal, compliance, and political risk).

ESM details activities and key risks

The ESM, like other similar IFIs, is subject to a number of financial and non-financial risks. These risks are a function of the ESM's mandate and operational activities, as well as its operating model and financial policies. The ESM therefore implements the appropriate procedures and processes to identify, assess, measure, monitor, and manage these risks.

The following section is aimed at presenting how the ESM manages and mitigates the main risks it faces, in full alignment with the institutional risk appetite statements.

Financial risks

Credit risk

Credit risk – the risk of loss arising from the inability of a counterparty, issuer, insurer, or other obligor to fulfil its contractual obligations. The ESM is exposed to credit risk from two sources: lending and stability support activities; and investment and funding operations.

LENDING AND STABILITY SUPPORT

Credit risk from lending – the risk of loss if ESM Members which have benefited from the ESM's financial stability support fail to fulfil their contractual obligations.

- Lending by the ESM is protected by **preferred creditor status**, junior only to the IMF, which is a strong measure mitigating the credit risk from lending.

- As part of its **Early Warning System**, the ESM assesses the ability of a beneficiary Member to repay its obligations. Findings are summarised in a regular report, which is considered by the Internal Risk Committee. This activity is in accordance with the mechanism for drawing down callable capital if required (see the publicly available Terms and conditions of capital calls for ESM).

Credit risk from Direct Recapitalisation Instrument – the risk of loss if there is a default by a financial institution on direct capital assistance in the form of equity and junior debt.

INVESTMENT AND FUNDING OPERATIONS

Issuer and counterparty risk – the risk of loss as a result of the non-fulfilment of contractual obligations.

Credit concentration risk – the risk of loss due to investments being too heavily concentrated in a particular issuer, class of issuer, sector, country, or similar category, and therefore being exposed to the risk that issuer and counterparty risk losses could be highly correlated.

The ESM is primarily exposed to these risks through its need to invest proceeds from its paid-in capital, the liquidity buffer and the reserve fund.

Credit limits and minimum credit quality thresholds mitigate credit risk exposure. Compliance with these thresholds is analysed independently by counterparty risk specialists and checked against the ratings assigned to counterparties, issuers, and individual issuances, by the three major rating agencies, Fitch, Standard and Poor's and Moody's. In addition, credit risk is also mitigated through the use of collateral, which is subject to eligibility requirements and margin calls. The ESM measures and monitors credit risk exposures and compliance with credit risk rules on a daily basis.

Market risk

Market risk – the risk of loss arising from changes in the values of financial assets and liabilities (including off-balance sheet items) due to price fluctuations in interest rates, foreign exchange, and other securities. Market risk can be structural (in relation to assets and liabilities) or non-structural (in relation to investments). The ESM has both types of market risk: structural for lending and funding activity, and non-structural for the investment of the paid-in capital.

The ESM's main market risk is interest rate risk – the risk of loss arising from adverse movements in market yields or the term structure of interest rates. Interest rate risk can manifest itself in different ways:

STRUCTURAL

- **General interest rate risk** – the risk of loss due to an adverse change in the overall level of interest rates acting on the net level of interest rate exposure between assets and liabilities.

- **Refinancing risk** – the risk of loss of income arising from the differences in maturity profiles of assets and liabilities (maturity mismatch or ALM risk) due to changes in the term structure of interest rates, i.e. steepening or flattening of the curve. Refinancing risk occurs when the maturity of assets is longer than the maturity of the liabilities used to fund them.

NON-STRUCTURAL

- **General interest rate risk** – the risk of loss due to an adverse change in the overall level of interest rates affecting the value of the investments. No profit or loss will be realised unless the investments are subsequently sold at the new interest rate level.

- **Basis risk** – the risk of loss due to an unexpected divergence in the spread between different sectors of the interest rate market used as the basis for pricing the investments, or between a derivative product and the exposure it is hedging.

Structural interest rate risk is controlled via cash flow projections performed by the ALM function, supported by a short-term liquidity buffer as described in the Guideline on Investment Policy. The ESM is required to maintain coverage of all outflows up to one year using the liquidity buffer and part of its capital. Even though all funding costs arising from refinancing risk are currently 'passed through' to beneficiary Members under financial assistance, as defined by the ESM Pricing Policy, the ESM measures and monitors this risk continually, since generally longer-dated assets are funded by shorter-dated liabilities.

Non-structural interest rate risk is controlled by a series of limits on portfolio duration, monitored daily. There are also longer-term value-at-risk limits for each tranche of the paid-in capital as described in the Guideline on Investment Policy. These are monitored by means of daily calculations, performed using a 99% confidence level, which are then converted to longer-term values and compared with risk appetite.

Value-at-risk does not measure the worst loss that could be experienced. Hence, in addition, various yield curve and market sensitivity stress tests are carried out daily, as well as periodic exercises related to economic scenarios that are reviewed by the risk committees.

The ESM recognises other market risks:

- **Credit spread risk** – the risk of loss on an investment in a debt security as a result of a decrease in the value of the security due to an actual or market-implied decrease in the creditworthiness of the issuer. Spread risk can be specific to a particular issuer or be driven by changes in sector, country, and other relevant spreads. This risk is controlled within the set of value-at-risk limits described above.

- **Foreign exchange risk** – the risk of loss arising from changes in exchange rates. The ESM currently funds only in euro, and invests predominantly in euro. The ESM has started limited activity in foreign currency assets, mainly Danish krona and Japanese yen (See also Chapter 2, Investment and Treasury, and Chapter 4, Financial Report).

- **Equity risk** – the risk of loss arising from changes in the price of equity instruments. These instruments could arise in the context of the Direct Recapitalisation Instrument, whereby the ESM would provide capital directly to certain eligible financial institutions. At present the ESM has not provided any such capital directly, hence it holds no equity risk.

Table 6: Daily and annualised value-at-risk comparison, 2013, 2014, and 2015

	Portfolio value in € million	1 day value-at-risk in € million	Daily % of portfolio value	Annualised % of portfolio value
31.12.2015	90,453	95	0.10%	1.66%
31.12.2014	84,694	110	0.13%	2.06%
31.12.2013	78,307	56	0.07%	1.13%

Source: ESM

Table 6 gives a daily and annualised value-at-risk comparison.

- By the end of 2014, the original paid-in capital amount had been fully paid in. Up until then, both the size of the paid-in capital and of investments increased in parallel, also pushing up the value-at-risk.

- By the end of 2015, the size of the liquidity buffer increased in anticipation of planned disbursements. At the same time, the targeted risk profile for investments was lowered, which resulted in a reduction of the value-at-risk of the portfolio.

Liquidity risk

The ESM faces two main types of liquidity risk:

- **Funding liquidity risk** – the risk of loss arising from difficulty in securing the necessary funding, or from a significantly higher cost of funding than normal levels, due to a deterioration of the ESM's creditworthiness, or at a time of unfavourable market conditions (such as periods of high stress).

- **Liquidity concentration risk** – the risk of loss arising from concentrations in assets and liabilities as major sources of liquidity, particularly in times of market stress.

The ESM addresses these liquidity risks by holding sufficient capital at all times, invested in appropriately liquid assets, plus an adequate liquidity buffer to cover short-term liquidity needs. The liquidity buffer is managed according to two principles: it must comply with sound liquidity risk management principles; and it may not become too large compared with these risks, so as not to generate excessive cost of carry for beneficiary Members. At the end of December 2015, the liquidity buffer stood at €8.7 billion (2014: €3.8 billion); on average in 2015 it was €11.4 billion (2014: €9.4 billion). (See also Chapter 4, Section 2.7.2).

The ESM continually monitors funding conditions, and stresses its projections of asset and liability cash flows based on a number of alternate assumptions. The institution further minimises liquidity risk through a diversified funding strategy. (See also Chapter 2, Funding activities.)

There is a third type of liquidity risk, **market liquidity risk** – the risk of loss arising from a position that cannot easily be unwound or offset at short notice without significantly influencing its market price due to inadequate market depth or market disruption. This risk is present in relation to the investment of the ESM's capital, and is controlled by limits such as the total proportion of a bond issuance that can be held.

Non-financial risks

The ESM is subject to a number of non-financial risks, which include operational risk, reputational risk, legal risk, compliance risk, and political risk. Each risk is carefully identified, assessed, and monitored by the relevant ESM department, with periodic oversight provided by the Internal Risk Committee and Board Risk Committee.

Reputational risk – the risk of loss and/or damage arising from a deterioration in the 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 is managed by the ESM undertaking its mandate in accordance with the highest professional standards and prudent management of all ESM's risks, and by having centralised coordination of external communication, including permanent media monitoring, regular meetings with journalists covering the ESM, and membership in a network of European institutions maintaining an alert on reputational risks.

Legal risk – the risk of loss as a result of inadequate or inefficient documentation, legal capacity, enforceability of national and international laws; litigation against the ESM or its assets; and 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 – 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. The Code of Conduct, as part of the ESM legal framework, defines the fundamental ethical principles to be assumed by ESM staff, such as the requirements regarding the employee's integrity and loyalty, guidelines for handling conflicts of interest, prohibitions on insider trading, restrictions on financial interest and rules regarding information secrecy. Following the approval of the Code of Conduct in March 2014, all staff underwent training and completed certification relating to the Code of Conduct.

Compliance risk is managed by the Compliance Officer who reports to the Chief Risk Officer and, on behalf of the Managing Director, identifies and assesses compliance risks, formulates policies in such areas as anti-money-laundering control and information barriers, and provides guidance and training to staff on compliance matters, particularly in relation to the Code of Conduct. A Compliance Charter, formulating the mandate of the Compliance function, is available on the ESM website.

Political risk – the risk of loss and/or damage arising as a result of a single or multiple political events that affect the ESM's ability to perform its mandate, for example, by reducing access to the market for funding. Political risk is managed principally by the Board of Governors and closely monitored by the Managing Director.

ESM BOLSTERS PROTECTION AGAINST TOP OPERATIONAL RISKS

The ESM steps up work on operational risk in line with other international financial institutions.

The ESM stepped up its work on operational risk in 2015, addressing a topic increasingly at the forefront of financial institutions' concerns as they contend with globalising markets and their complex transactions. Operational risk is the potential loss and/or damage (such as the inability of the ESM to fulfil its mandate) resulting from inadequate or failed internal processes, people, and systems, or from external events. Like other international financial institutions, the ESM confronts particular operational risks including cyber security, dependence on outsourced service providers, challenges associated with data management, business continuity, and resilience. The categorisation of the ESM operational risks is based on guidance from the Basel Committee on Banking Supervisions, as follows:

- execution, delivery, and process management;
- counterparts, products, and business practices;
- internal and external fraud;
- business continuity and system failures;
- employment practices and workplace safety; and
- damage to physical assets.

In 2015, the ESM carries out its first annual fraud risk assessment.

In response, the ESM strengthened its operational risk toolkit over the year. It deployed new, enhanced tools to identify financial and non-financial risks, assess their likelihood, and their financial and reputational effect. As needed, it devised methods to manage these risks or to limit the organisation's exposure to the risk. The ESM, for example, carried out its first annual fraud risk assessment in 2015. Based on the results, it created and rolled out a best practice fraud risk management programme. This programme specifies how the business units, the risk department, and, finally, the auditors (i.e. the three lines of defence) should tackle fraud and misconduct risks. Other advancements included the ESM's first annual business continuity risk assessment. To guarantee staff preparedness, the ESM also runs regular simulations of threats to business continuity to ensure a robust business continuity capability is maintained.

ESM operational risk management policy stipulates no tolerance for material operational risks, very low tolerance for all other operational risks.

The ESM, which operates under a conservative overarching risk policy, implements and monitors key risk indicators for high risk areas. The ESM operational risk management policy stipulates no tolerance for material operational risks and a very low tolerance of 0.02% of paid-in capital (two basis points) with 99% confidence for other, more minor losses. If any operational risk materialises, they are reported to an internal operational risk register, and a root cause analysis of the issue is conducted, along with follow-up to address the issue via the risk committees, and, where necessary, the Board of Directors. To review the overall risk management practice, the ESM runs an annual risk and compliance framework review, benchmarking the ESM's risk management practice to identify areas for improvement.

TRANSPARENCY AND ACCOUNTABILITY

- **Communications and economics launch two new paper series**
- **ESM boosts transparency, releasing yet more documents on programme countries**

The ESM, whose mandate is to safeguard financial stability in the euro area, is committed to explaining its role and activities so that all those interested can better understand the organisation and what it does. During the period covered by this report, the ESM made good on this pledge by increasing its external presence, launching a new initiative to make more of its documents public, and kick-starting two new series of publications.

With a new Greek programme throwing the public spotlight on the ESM, the Managing Director and ESM senior staff used their frequent public appearances to explain, for example, economic developments in the euro area Member States, particularly those with assistance programmes. Greece was a particular focus, of course, following euro area-wide agreement in summer 2015 to launch a new loan programme for up to €86 billion. The speeches, interviews, presentations and video recordings are available on the ESM's website: www.esm.europa.eu.

ESM Managing Director Klaus Regling (left), welcomes Mark Rutte, Prime Minister of the Netherlands, to the ESM in September 2015.

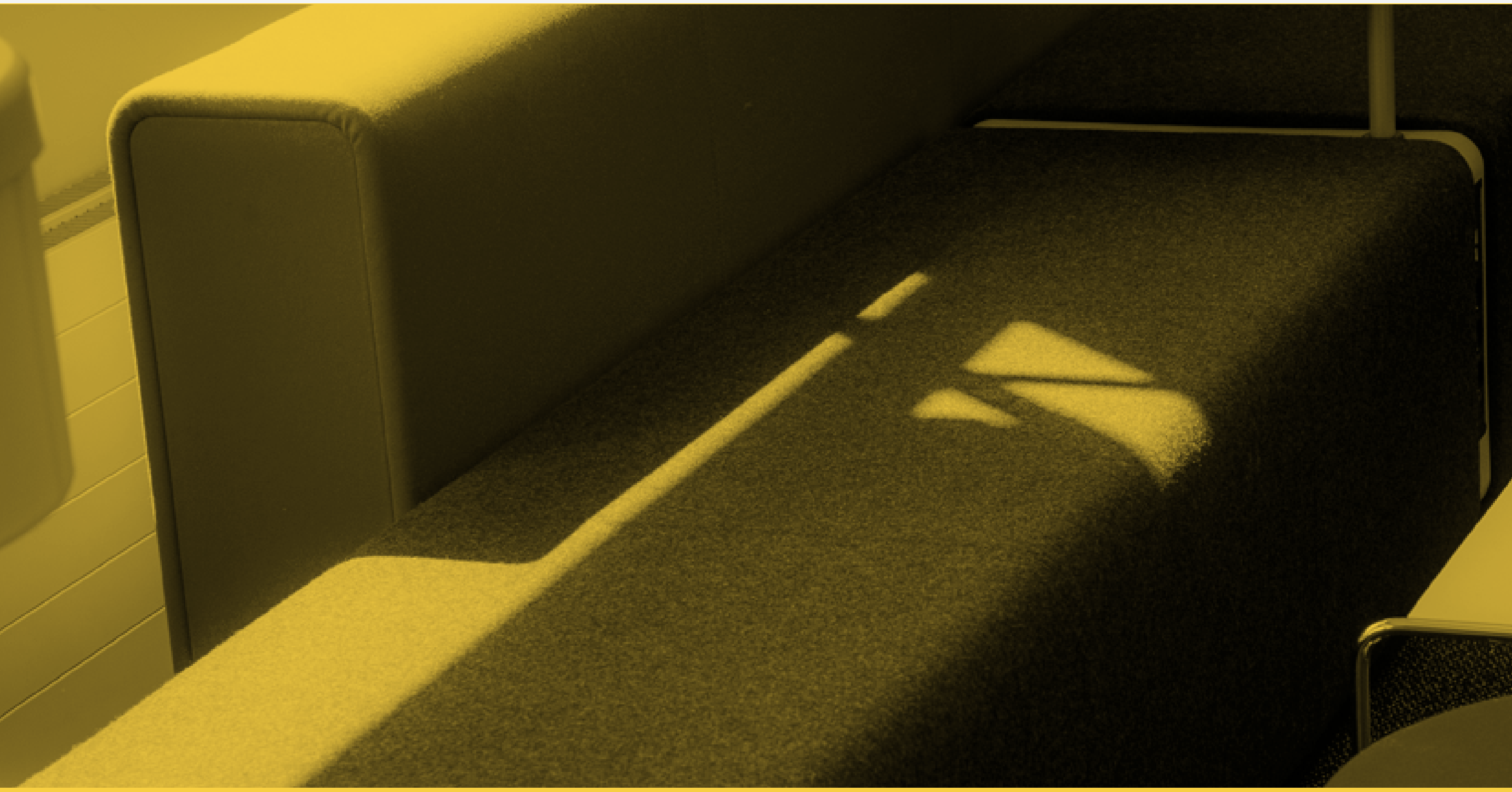
As a publicly funded international institution, the ESM also decided to enhance the transparency of its decision making. While the ESM already publishes on its website the key documents on programme countries that its governing bodies have adopted, from spring 2016 it will make more loan programme documents available at an earlier stage.

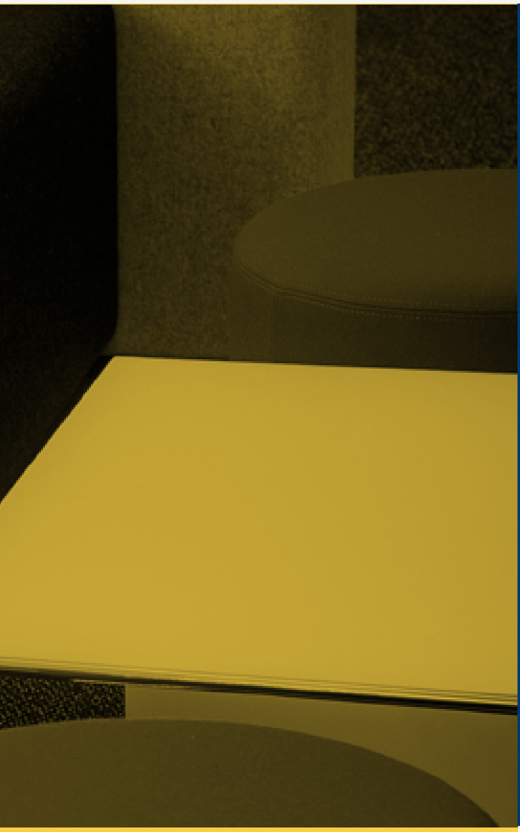
The ESM now plans to disclose, in a more systematic and timely fashion, ESM programme documents discussed at the ESM Board of Governors, the ESM Board of Directors, and the Eurogroup, an informal meeting group of the euro area Finance Ministers. These will include annotated agendas and summaries of key decisions as well as proposals made but as yet to be approved by either board and before they go through any national procedures, if applicable.

Documents that might jeopardise effective crisis resolution or imply legal action by third parties, such as draft documents or market sensitive information, would be an exception.([12]) This ESM transparency initiative complements a similar move by the Eurogroup.

To adequately fulfil its mandate, the ESM employs skilled and well-regarded economists who research topics related to the rescue fund's mission. This work has allowed the ESM to launch two paper series. In 2016, the ESM began publishing a discussion paper series, which offers overviews and analyses of topics relevant to the activities and mandate of the ESM. These discussion papers are intended to inform and stimulate the public policy discussion. This follows the 2015 launch of the ESM working paper series, featuring scholarly contributions on economic topics authored or co-authored by staff. Both series reflect the opinions of the authors, not the ESM.

([12]) In accordance with Article 17 of the ESM By-Laws, the ESM rules on the disclosure of documents are without prejudice to applicable legal provisions governing the exchange of information between national governments and parliaments of ESM Members.





03

INSTITUTIONAL FRAMEWORK AND ORGANISATION

ESM'S FINANCIAL ASSISTANCE TOOLKIT

PRIMARY MARKET PURCHASES

Objective: the ESM may engage in primary market purchases of bonds or other debt securities issued by ESM Members at market prices to allow them to maintain or restore their relationship with the investment community and therefore reduce the risk of a failed auction. This can complement the regular loan instrument or a precautionary programme. The purchase will be limited to 50% of the final issued amount.

Conditionality: no additional conditionality beyond the underlying programme.

LOANS WITHIN A MACROECONOMIC ADJUSTMENT PROGRAMME

Objective: to assist ESM Members in significant need of financing, but which have lost access to the markets, either because they cannot find lenders or because the financing costs would adversely impact the sustainability of public finances.

Conditionality: ESM loans are conditional upon the implementation of macroeconomic reform programmes prepared by the EC, in liaison with the ECB and, where appropriate, the IMF.

Monitoring: the same institutions are entrusted with monitoring compliance with the agreed programme conditions for economic reform. The ESM Member is obliged to cooperate with this monitoring and enable the ESM to perform its financial due diligence. If the country deviates significantly from the programme, disbursements may be withheld.

SECONDARY MARKET PURCHASES

Objective: to support the sound functioning of the government debt markets when lacking market liquidity threatens financial stability in the context of a loan either with a macroeconomic adjustment programme or without if the Member's economic and financial situation is fundamentally sound.

Conditionality: for ESM Members not under a programme, specific policy conditions will apply.

PRECAUTIONARY CREDIT LINE

Objective: to support sound policies and prevent crisis situations from emerging. It aims to help ESM Members whose economic conditions are sound to maintain continuous access to market financing by strengthening the credibility of their macroeconomic performance.

Two types of credit lines: both can be drawn via a loan or a primary market purchase, have an initial availability period of one year and are renewable:

- Precautionary Conditioned Credit Line (PCCL): available to a Member State whose economic and financial situation is fundamentally sound, as determined by respecting six eligibility criteria such as public debt, external position or market access on reasonable terms.
- Enhanced Conditions Credit Line (ECCL): access open to euro area Member States whose economic and financial situation remains sound but that do not comply with the eligibility criteria for PCCL. The ESM Member is obliged to adopt corrective measures addressing such weaknesses and avoiding future problems in respect of access to market financing.

The ESM Member has the flexibility to request funds at any time during the availability period.

Monitoring: when an ECCL is granted or a PCCL drawn, the ESM Member is subject to enhanced surveillance by the EC. Surveillance covers the country's financial condition and its financial system.

LOANS FOR INDIRECT BANK RECAPITALISATION

Objective: to preserve the financial stability of the euro area by addressing those cases where the financial sector is primarily at the root of a crisis, rather than fiscal or structural policies.

Eligibility: the beneficiary Member State should demonstrate an inability to:

- Meet capital shortfalls via private sector solutions.
- Recapitalise the institutions without adverse effects for its own financial stability and fiscal sustainability.

The institutions should be of systemic relevance or pose a serious threat to the financial stability of the euro area or its Member States. The ESM Member should demonstrate its ability to reimburse the loan.

Conditionality: will apply to financial supervision, corporate governance and domestic law relating to restructuring or resolution.

Monitoring: the EC enforces compliance with EU state aid rules and also monitors other policy conditions with the ECB and the relevant supervisory authority.

DIRECT RECAPITALISATION OF INSTITUTIONS

Objective: to help remove a serious risk of contagion from the financial sector to the sovereign by allowing the direct recapitalisation of institutions. The total amount available for this instrument is limited to €60 billion.

The instrument is relevant for banks (systemically important credit institutions), financial holding companies, and mixed financial holding companies as defined in relevant EU legislation.

Eligibility: the relevant institutions are considered eligible if the following situations apply:

- They are or are likely to be in breach of the relevant capital requirements and are unable to attract sufficient capital from private sector sources to resolve their capital problems.
- Burden-sharing arrangements, such as bail-in (fully applicable in 2016), in the Bank Recovery and Resolution Directive, are insufficient to fully address the capital shortfall.
- They have a systemic relevance or pose a serious threat to the financial stability of the euro area as a whole or the requesting ESM Member.
- The institution is supervised by the ECB.
- The beneficiary Member State should also demonstrate that it cannot provide financial assistance to the institutions without very adverse effects on its own fiscal sustainability, and that therefore the use of the indirect recapitalisation instrument is infeasible.

Conditionality: will apply, addressing the sources of difficulties in the financial sector and, where appropriate, the general economic situation of the ESM Member. Additional institution-specific conditions will also apply.

GOVERNANCE

ESM shareholders

The ESM shareholders are the 19 euro area Member States, which are also referred to as ESM Members. Each Member contributes to the ESM's authorised capital based on the ESM Members' respective shares of the EU total population and gross domestic product.

The accession of new Member States is factored into the capital key, slightly reducing the founding ESM Members' contribution keys. Nominal capital subscription and paid-in capital amounts remain unchanged.

In line with Article 42 of the ESM Treaty, ESM Members with a gross domestic product (GDP) per capita of less than 75% of the EU average in the year immediately preceding their ESM accession benefit from a temporary correction mechanism. Both recent ESM joiners, Latvia and Lithuania, benefit from this temporary correction, which applies for 12 years after the date of their respective euro adoption. During this period, the initial capital subscription of the ESM Member benefiting from the correction will be lower, thus leading temporarily to a lower paid-in capital contribution. Once this period comes to an end, the ESM Member must deposit the remaining amount.

Latvia officially became the 18th ESM Member on 13 March 2014. Qualifying for a temporary correction, its capital subscription is €1.93 billion, including €221.2 million in paid-in capital. Latvia is making the payments of paid-in capital in five annual instalments of €44.24 million each. Latvia paid the first instalment on 19 March 2014, the second on 18 March 2015, and the third on 18 March 2016. Once the temporary correction comes to an end in 2026, Latvia must deposit the remaining €102.9 million.

Lithuania officially became the 19th ESM Member on 3 February 2015. It also qualifies for a temporary correction. Lithuania's capital subscription is €2.86 billion, including €327.2 million in paid-in capital. Lithuania is making the paid-in capital payments in five annual instalments of €65.44 million each. Lithuania paid the first instalment on 11 February 2015 and the second instalment on 10 February 2016. The remaining three instalments will be paid annually through 2019. Once the temporary correction comes to an end in 2027, Lithuania is required to deposit the remaining €159.4 million.

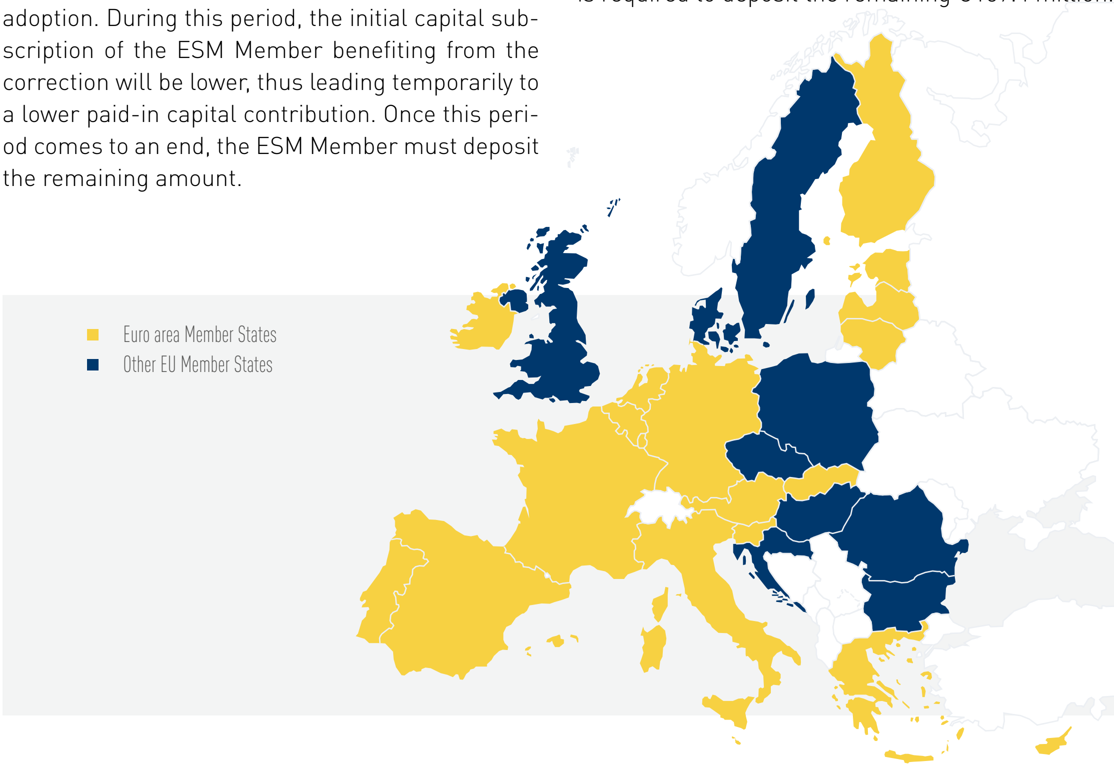
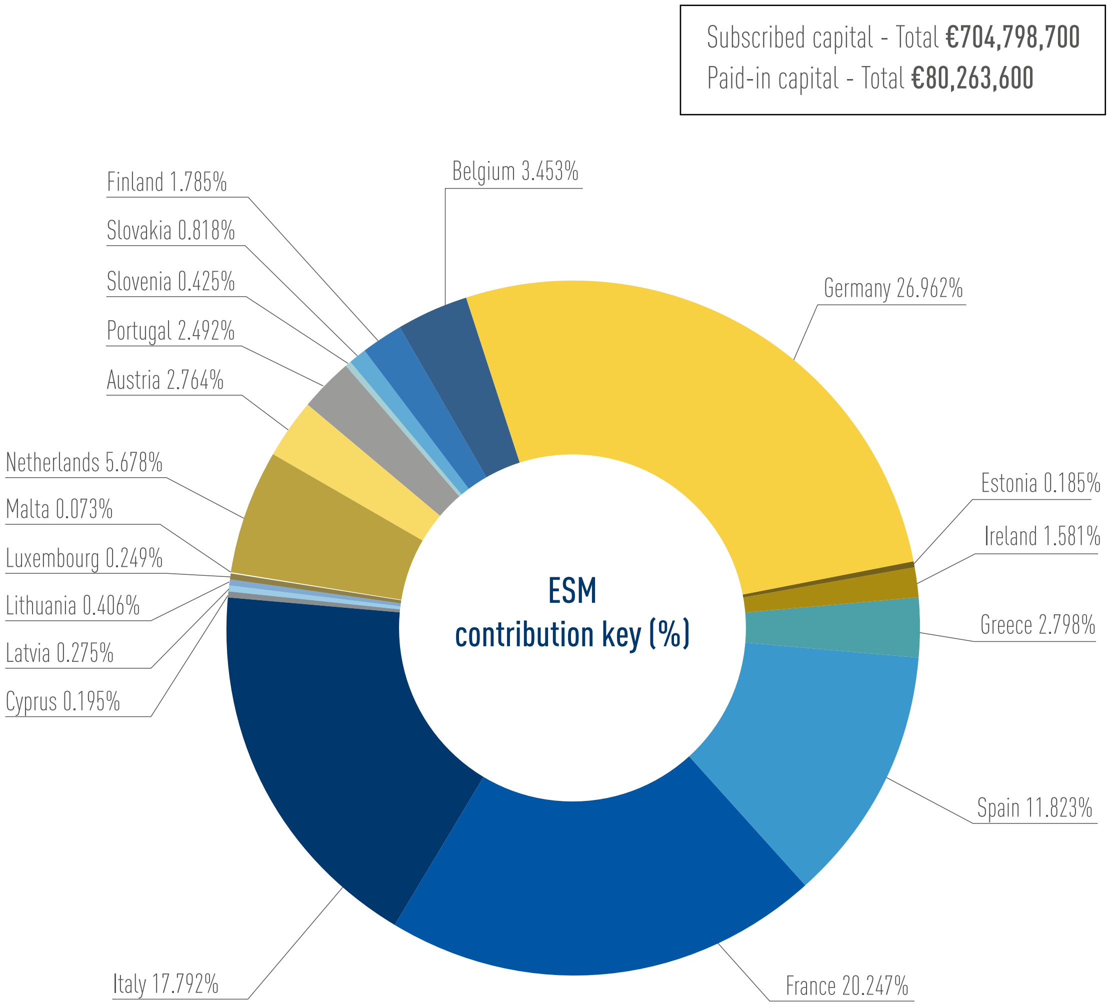
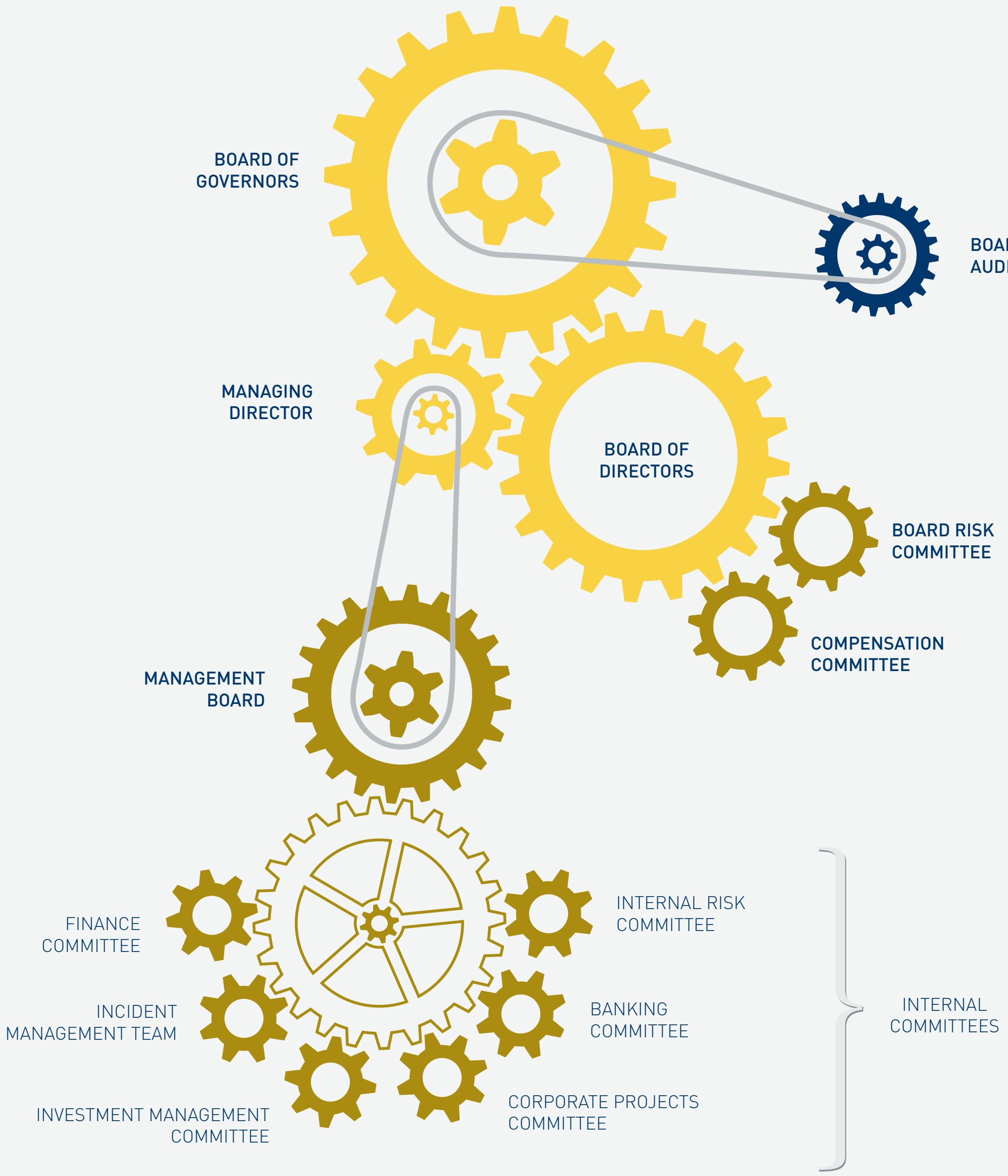


Figure 42: ESM contribution key, by ESM Member



GOVERNANCE STRUCTURE



The Board of Governors is the highest decision-making body of the ESM. It comprises government representatives of each ESM Member with responsibility for finance. Representatives of the European Commission and the ECB may participate in its meetings as observers. The Board of Governors is chaired by the President of the Eurogroup.

The Board of Auditors is an independent oversight body. Its five members are appointed by the Board of Governors upon proposal of the Chairperson of the Board of Governors, the supreme audit institutions of the ESM Members based on a system of rotation, and the European Court of Auditors.

The Board of Directors consists of representatives from each ESM Member with high competence in economic and financial matters. The European Commission and the ECB may participate in its meetings as observers. The Board of Directors ensures that the ESM is run in accordance with the ESM Treaty and By-Laws.

The Board Risk Committee is a permanent sub-committee of the Board of Directors advising it on the overall current and future risk appetite of the ESM. It also assists the Board of Directors in defining, reviewing, and overseeing the implementation of the ESM risk management framework by the Managing Director.

The Compensation Committee is a permanent sub-committee of the Board of Directors advising the Board of Directors and the Managing Director on matters of staff compensation, the framework and principles of staff compensation, the total annual salary mass, and the evolution of the salary band boundaries.

The Managing Director, Klaus Regling, is appointed by the Board of Governors and responsible for conducting the current business of the ESM under the direction of the Board of Directors. The Managing Director chairs the meetings of the Board of Directors and participates in those of the Board of Governors. He is the ESM's legal representative and chief of staff.

The Management Board assists the Managing Director in conducting the current business of the ESM, preparing the decisions of the Board of Governors and the Board of Directors and seeing to their implementation.

INTERNAL COMMITTEES

There are currently six Internal Committees in place, which are directly empowered by delegated authority from the Managing Director.

Finance Committee approves and takes action on matters related to ESM structural risks as defined in the ESM Risk Policy, mainly re-financing, liquidity and interest rate risks related to its operations.
Chair: Managing Director

Internal Risk Committee considers any matters regarding the evaluation, monitoring and approving of practices linked to the implementation of the ESM Risk Management Framework and risk management within ESM operations.
Chair: Chief Risk Officer

Investment Management Committee considers matters regarding the implementation of the ESM Guideline on Investment Policy for the ESM Investment Portfolios and the Liquidity Buffer.
Chair: Deputy Managing Director and Chief Financial Officer

Corporate Projects Committee prioritises, approves, and oversees the execution of all ESM corporate projects.
Chair: Management Board Member for Funding, ALM & Lending, and Secretary General

Banking Committee performs technical reviews and provides final internal approval prior to the submission of proposals linked to the direct recapitalisation instrument (DRI) to the Board of Governors, Board of Directors or any other external counterparties. The Banking Committee only convenes in the context of a DRI operation and therefore has not formally met so far.
Chair: Managing Director

Incident Management Team oversees the development and implementation of an effective business continuity capability within the ESM and coordinates the ESM response in the event of incidents that may affect normal ESM operations.
Chair: Management Board Member for Funding, ALM & Lending, and Secretary General.

BOARD OF GOVERNORS

Key decisions

The Board of Governors meets at least once a year and whenever the affairs of the ESM so require.

In 2015, the Board of Governors held four meetings and took the following key decisions:

- approval of the ESM 2014 Annual Report (18 June 2015);
- approval of two updates to the Memorandum of Understanding with Cyprus (18 June 2015 and 5 October 2015);
- approval of a new stability support programme for Greece (17 July 2015);
- approval of the proposal by the Managing Director for a Financial Assistance Facility Agreement with Greece (19 August 2015);
- approval of a Memorandum of Understanding with Greece (19 August 2015);
- appointments to the Board of Auditors: Jean Guill upon proposal of the Chairperson of the Board of Governors and Andrew Harkness upon nomination by the Irish Supreme Audit Institution (5 October 2015).

Annual Meeting of the Board of Governors

On 18 June 2015, the Board of Governors held its third annual meeting at the ESM premises in Luxembourg during which it approved the ESM 2014 Annual Report as drawn up by the ESM Managing Director.

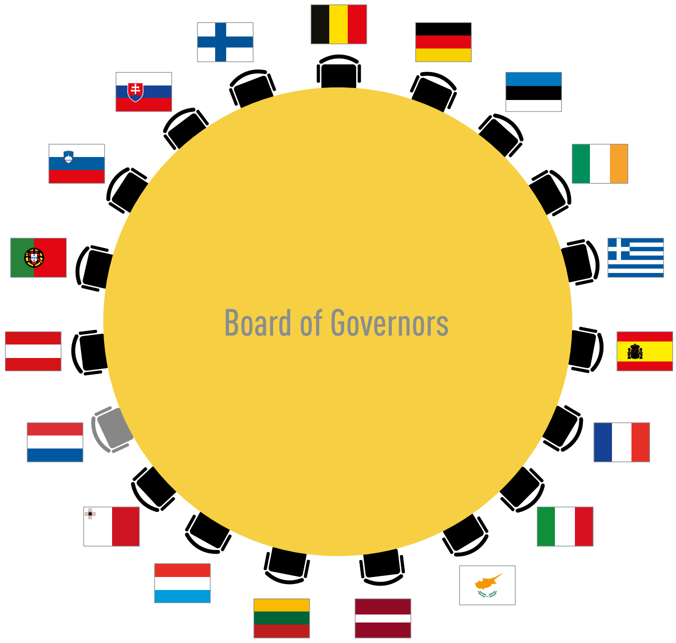
In addition, the Chairperson of the Board of Auditors and the external auditor addressed the Governors with regard to the Report of the Board of Auditors in respect of the ESM 2014 Financial Statements.

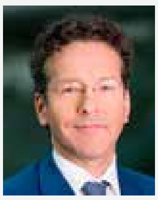
The Managing Director presented the Governors with an overview of key ESM developments and institutional affairs over the past financial year. The annual meeting also allowed the ESM management and staff to have a direct exchange with the ESM Governors.

The Governors congratulated the Managing Director and the ESM staff on the progress made by the institution in 2015 noting that the ESM was gaining recognition in the overall architecture of the European Economic and Monetary Union.

Klaus Regling, Managing Director of the ESM (left), and Jeroen Dijsselbloem, Chairperson of the ESM Board of Governors (right), hold a press conference following the annual Board of Governors meeting in June 2015.

Members of the Board of Governors





NETHERLANDS

Jeroen Dijsselbloem,
Chairman of the Board of Governors,
Minister of Finance,
Governor since 27 September 2012

ESTONIA

Sven Sester,
Minister of Finance,
Governor since 9 April 2015,
replacing Maris Lauri,
Governor since 3 November 2014

BELGIUM

Johan Van Overtveldt,
Minister of Finance,
Governor since 15 December 2014

IRELAND

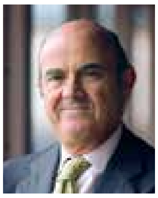
Michael Noonan,
Minister of Finance,
Governor since 27 September 2012

GERMANY

Wolfgang Schäuble,
Federal Minister of Finance,
Governor since 27 September 2012

GREECE

Euclid Tsakalotos,
Minister of Finance,
Governor since 6 July 2015
replacing Yanis Varoufakis,
Governor since 27 January 2015

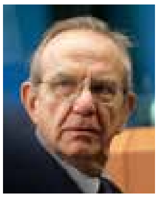


SPAIN

Luis de Guindos Jurado,
Minister of Economy and Competitiveness,
Governor since 27 September 2012

FRANCE

Michel Sapin,
Minister of Finance and Public Accounts,
Governor since 2 April 2014



ITALY

Pier Carlo Padoan,
Minister of Economy and Finance,
Governor since 22 February 2014

CYPRUS

Harris Georgiades,
Minister of Finance,
Governor since 3 April 2013

LATVIA

Dana Reizniece-Ozola,
Minister of Finance,
Governor since 22 March 2016
replacing Jānis Reirs,
Governor since 5 November 2014

LITHUANIA

Rimantas Šadžius,
Minister of Finance,
Governor since 3 February 2015

LUXEMBOURG

Pierre Gramegna,
Minister of Finance,
Governor since 4 December 2013

MALTA

Edward Scicluna,
Minister of Finance,
Governor since 13 March 2013

AUSTRIA

Hans Jörg Schelling,
Minister of Finance,
Governor since 1 September 2014

PORTUGAL

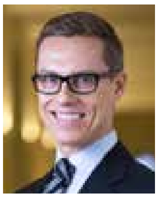
Mário Centeno,
Minister of Finance,
Governor since 26 November 2015
replacing Maria Luís Albuquerque,
Governor since 2 July 2013

SLOVENIA

Dušan Mramor,
Minister of Finance,
Governor since 18 September 2014

SLOVAKIA

Peter Kažimír,
Deputy Prime Minister and Minister of Finance,
Governor since 27 September 2012



FINLAND

Alexander Stubb,
Minister of Finance,
Governor since 11 June 2015
replacing Antti Rinne,
Governor since 6 June 2014

The ESM welcomes representatives from the finance ministries of ESM Members to its second annual Shareholders Day on 29 and 30 September 2015.

Shareholder engagement

The ESM places great emphasis on shareholder relations and engagement. The ESM participated in the various political fora where its shareholders are represented to discuss matters of relevance to its mandate, such as the Eurogroup, the Eurogroup Working Group, and the Task Force for Coordinated Action.

Furthermore, in 2015, the ESM organised its second Shareholders Day, during which the ESM welcomed representatives from the finance ministries of the various ESM Members for a mutual exchange and to help deepen their technical understanding of ESM operations.

The ESM also officially launched an online shareholder relations tool, the ESM Board Portal, in 2015. It covers Board activities, institutional reporting, and archives and allows for extended communication with the ESM shareholders via a secure online interface.

BOARD OF DIRECTORS

Key decisions

In 2015, the Board of Directors, whose meetings are chaired by the Managing Director, met 15 times and took the following key decisions:

- appointments:
  - Irena Sodin as a new member of the Board Risk Committee (2 July 2015);
  - reappointment of Vincenzo La Via as a member of the Board Risk Committee (6 October 2015);
  - reappointment of Isabelle Goubin as a member of the Compensation Committee (6 October 2015);
- approval of the Financial Assistance Facility Agreement with Greece (19 August 2015);
- approval of the disbursement of:
  - The seventh and eighth tranches of financial assistance to Cyprus (2 July 2015 and 6 October 2015);
  - The first tranche to Greece first, second and third disbursement under sub-tranche A (19 August 2015, 23 November 2015 and 22 December 2015) and first and second disbursement under sub-tranche B (1 December 2015 and 8 December 2015);
- drawing up of the ESM 2014 Financial Statements (25 March 2016);
- endorsement of the description of policies and activities of the ESM contained in the ESM 2014 Annual Report (20 May 2015);
- approval of the voluntary early repayment of the ESM loan by Spain (2 July 2015);
- approval of the ESM 2016 administrative budget (26 November 2015);
- approval of adaptations to the ESM lending documentation (4 February 2016).

ESM Directors at a Board of Directors' meeting.

Members of the Board of Directors

CHAIR OF THE MEETINGS
OF THE BOARD OF DIRECTORS

Klaus Regling
ESM Managing Director

ESTONIA
Märten Ross,
Deputy Secretary General for Financial Policy and External Relations, Ministry of Finance, appointed on 21 October 2013

BELGIUM
Steven Costers,
Counselor General, Ministry of Finance, appointed on 1 May 2015 replacing Jozef Kortleven, originally appointed on 28 September 2012

IRELAND
Nicholas O'Brien,
Assistant Secretary General, Department of Finance, appointed on 3 July 2014
Member of the Compensation Committee since 30 September 2014 until 9 October 2016

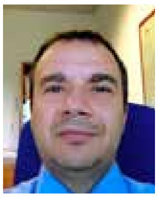
GERMANY
Thomas Steffen,
State Secretary, Federal Ministry of Finance, appointed on 24 September 2012
Member of the Compensation Committee since 9 October 2012, reappointed until 9 October 2017

GREECE
George Chouliarakis,
Alternate Minister of Finance, appointed on 4 February 2015, replacing Anastasios Anastasatos, originally appointed on 13 November 2014

SPAIN
Rosa María Sánchez-Yebra Alonso,
Secretary General for the Treasury and Financial Policy, Ministry of Finance,
appointed on 25 September 2014
Member of the Compensation Committee from 9 October 2014 until 9 October 2017

FRANCE
Bruno Bézard,
Director General of the Treasury, Ministry of Finance and Public Accounts,
appointed on 2 July 2014

ITALY
Vincenzo La Via,
Director General of the Treasury, Ministry of Economy and Finance,
appointed on 4 October 2012
Chairman of the Board Risk Committee since 9 October 2012, reappointed until 8 October 2018



CYPRUS
George Panteli,
Head of Economic Research and European Union Affairs Directorate, Ministry of Finance,
appointed on 29 April 2013

LATVIA
Līga Kļaviņa,
Deputy State Secretary, Ministry of Finance,
appointed on 30 January 2015,
replacing Baiba Bāne, State Secretary,
originally appointed on 22 July 2014

LITHUANIA
Miglė Tuskienė,
Financial Counsellor, Ministry of Finance,
appointed on 4 March 2015

LUXEMBOURG
Isabelle Goubin,
Director of the Treasury, Ministry of Finance,
appointed on 19 March 2014
Member of the Compensation Committee since 24 April 2014, reappointed until 8 October 2018

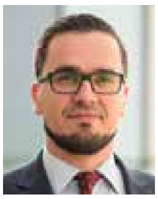
MALTA
Alfred Camilleri,
Permanent Secretary, Ministry of Finance,
appointed on 28 September 2012
Member of the Compensation Committee since 9 October 2012
Chairman of the Compensation Committee from 24 April 2014 until 9 October 2016

NETHERLANDS
Hans Vijlbrief,
Treasurer-General, Ministry of Finance,
appointed on 5 October 2012
Member of the Board Risk Committee since 9 October 2012, reappointed until 9 October 2017

AUSTRIA
Harald Waiglein,
Director General for Economic Policy and Financial Markets, Federal Ministry of Finance,
appointed on 8 October 2012
Member of the Board Risk Committee from 9 October 2012 until 8 October 2016

PORTUGAL
Ricardo Mourinho Félix,
Secretary of State for Treasury and Finance, Ministry of Finance, appointed on 7 December 2015,
replacing Isabel Castelo Branco,
originally appointed on 14 January 2014

SLOVENIA
Irena Sodin,
State Secretary, Ministry of Finance, originally appointed on 24 October 2014
Member of the Board Risk Committee from 2 July 2015 until 9 October 2017



SLOVAKIA
Ivan Lesay,
State Secretary, Ministry of Finance, appointed on 24 June 2015
replacing Vazil Hudák,
appointed on 28 September 2012

FINLAND
Tuomas Saarenheimo,
Permanent Under-Secretary, Ministry of Finance,
appointed on 12 September 2013

BOARD OF AUDITORS

The Board of Auditors inspects the ESM accounts and verifies that the operational accounts and the balance sheet are in order. Furthermore, it audits the regularity, compliance, performance, and risk management of the ESM in accordance with international auditing standards and monitors the ESM internal and external audit processes and their results.

The first members of the Board of Auditors were appointed on 8 October 2012 for a non-renewable term of three years, with the exception of Katarína Kaszasová and Ulrich Graf, whose names were drawn by lot to be appointed for a non-renewable term of four years to ensure board continuity. New members to the Board of Auditors are appointed for a non-renewable term of three years.

In October 2015, the three-year mandates of Marc Gengler, who was nominated by the Luxembourg Supreme Audit Institution, and Jules Muis, who was nominated by the Chairperson of the Board of Governors, expired. Ms Kaszasová, who was nominated by the Chairperson of the Board of Governors, resigned from the Board of Auditors as of 31 December 2015, due to changes in her professional engagements.

In accordance with the nomination protocol set out in the ESM Treaty and the ESM By-Laws, the Irish Supreme Audit Institution, nominated Andrew Harkness, Secretary and Director of Audit to the Board of Auditors, to replace Mr Gengler.

The Board of Governors appointed Jean Guill as the successor of Mr Muis upon proposal of the Board of Governors Chairperson.

In line with the ESM Treaty and the ESM By-Laws, the Board of Governors appointed Günter Borgel to replace Ms Kaszasová on 24 March 2016.

In 2015, the Board of Auditors held nine meetings and met once with the ESM Board of Directors. The Chairperson of the Board of Auditors met with the Chairperson of the Board of Governors and attended the annual meeting of the Board of Governors. At these meetings, ESM management and senior staff updated the Board of Auditors regularly on ESM activities, the ESM governing bodies, and other relevant issues and developments.

The ESM also provided the Board of Auditors with presentations and written opinions by the ESM management as well as by external experts. The Board of Auditors met regularly with the internal audit function and monitored and reviewed the work and independence of the external auditors.

In fulfilling its role, the Board of Auditors also reviewed the ESM Financial Statements as at 31 December 2015 and the working papers of the external auditor. The Board of Auditors carried out a follow-up audit of the ESM Risk Management in February 2015 and an audit of the ESM Funding Operations in November 2015.

The Board of Auditors prepares an Annual Report in respect of the ESM Financial Statements which is contained in the ESM Annual Report in addition to the External Audit Opinion. The Board of Auditors also draws up an Annual Report for the Board of Governors which summarises its audit work and its recommendations for the respective year. This report is made accessible to the national parliaments and the supreme audit institutions of the ESM Members, as well as to the European Court of Auditors and the European Parliament.

Members of the Board of Auditors

Igors Ludboržs

Chairperson since 8 October 2015
Member since 17 December 2013
Appointed upon nomination by the European Court of Auditors

Andrew Harkness

Vice Chairperson since 8 October 2015
Member since 8 October 2015
Appointed upon nomination by the Supreme Audit Institution of Ireland

Ulrich Graf

Chairperson from 8 October 2014 until 7 October 2015
Vice Chairperson from 21 March 2014 until 7 October 2014
Member since 8 October 2012
Appointed upon nomination by the Supreme Audit Institution of the Federal Republic of Germany

Jean Guill

Member since 8 October 2015
Appointed upon proposal of the Chairperson of the Board of Governors

Günter Borgel

Member since 1 April 2016
Appointed upon proposal of the Chairperson of the Board of Governors

INTERNAL CONTROL FRAMEWORK

The ESM recognises the importance of internal controls, which provide a reasonable assurance that the institution can deliver on its mandate, prevent losses, and prepare reliable financial statements free from material misstatements.

In 2015, the ESM completed the establishment of a comprehensive system of internal controls aligned with principles of the Basel Committee's Framework for Internal Control Systems in Banking Organisations.[13] The ESM internal control framework comprises entity level controls, process level controls, and Information Technology (IT) controls consistent with the nature, complexity, and risks inherent in ESM activities.

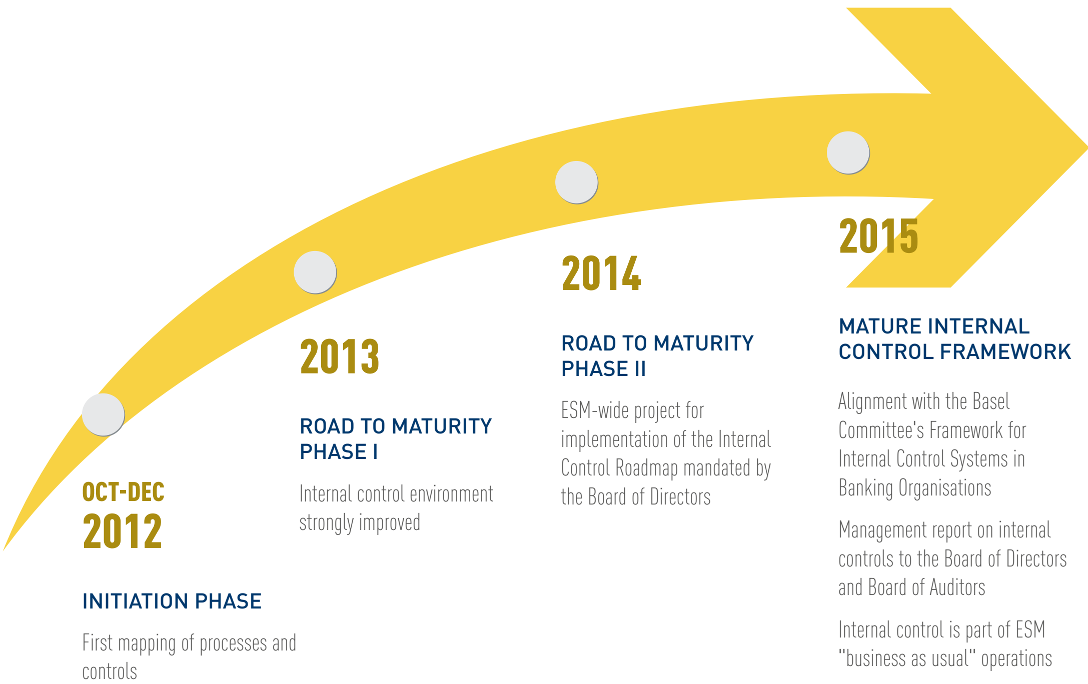
[13] Framework for Internal Control Systems in Banking Organisations, Basel Committee on Banking Supervision, Basel, September 1998.

The Board of Directors, directly and through the Board Risk Committee, includes in its activities periodic discussions with management on the adequacy and effectiveness of the ESM internal control framework.

The Managing Director, under the direction of the Board of Directors, is responsible for the establishment and ongoing maintenance of the ESM internal controls. The Managing Director, assisted by the Management Board, fulfils this responsibility by setting a strong tone from the top; a commitment to integrity and ethical values; oversight of internal controls across all areas of the ESM; and the assignment of clear roles and responsibilities.

The ESM internal controls cover all departments of the ESM and are underpinned by the three lines of defence governance model established by the Board of Directors.

Evolution of the ESM Internal Control Framework



ESM Internal Control Framework

ENTITY LEVEL CONTROLS

Seek to ensure that management directives pertaining to the entire entity are carried out effectively. They have a pervasive effect on the institution and include elements such as: management oversight and control culture, risk recognition and assessment, reliable information systems and availability of information relevant to decision making, as well as processes for monitoring and correcting deficiencies.

PROCESS LEVEL CONTROLS

Include operational controls embedded in key processes and transactions. Such controls are established for all processes and transactions affecting the ESM accounts.

IT CONTROLS

Comprise controls over the IT environment, computer operations, access to programs and data, program development, and program changes as well as automated transaction processing controls.

Internal controls are subject to scrutiny by management and periodic independent review by Internal Audit, and are revised as deemed necessary. Each year, the Managing Director issues a management report on the effectiveness of the ESM internal control framework to the Board of Directors and the Board of Auditors. A copy of the report is also provided to the external auditor. Any material or significant deficiencies identified during the management's assessment are noted in the report together with the management action plans to address them. There are inherent limitations to the effectiveness of any system of internal controls, including the possibility of human error or the circumvention of overriding controls. Therefore, even an effective internal control framework can provide only reasonable assurance. Based on the management's assessment of internal controls, no material or significant deficiencies had been identified as of 31 December 2015.

Internal Audit provides an independent assurance on the effectiveness of the established internal controls and procedures as part of the regular audit cycle. Furthermore, Internal Audit independently reviews the entity level controls on an annual basis in recognition of their pervasive effect on the organisation.

The external auditor gains an understanding of the ESM's internal controls to the extent that this is relevant for providing reasonable assurance on the accuracy of the ESM's financial statements. Material weaknesses in controls identified by the external auditor are reported to management, the Board of Directors, and the Board of Auditors. Furthermore, any instances of fraud found by the external auditor, regardless of materiality, are communicated to the appropriate level of management. If fraud involves senior management or if it is material to the ESM, it is reported by the external auditor to the Board of Directors and the Board of Auditors. No instances of fraud were identified in 2015.

The Board of Auditors meets periodically with management to review and monitor the internal controls of the ESM. The external auditor and the internal auditors regularly meet with the Board of Auditors, with or without management, to discuss internal control issues. The Board of Auditors issues recommendations for improvements in the ESM internal controls in its audit reports to management and in the Board of Auditors' Annual Report to the Board of Governors.

ORGANISATION

ESM Organisational Structure

AS OF 1 APRIL 2016

This organisational chart, which took effect on 1 April 2016, reflects a partial redistribution of the roles of two Management Board Members. With this redistribution, Christophe Frankel, ESM Deputy Managing Director and Chief Financial Officer, remains in charge of Investment & Treasury and assumes responsibility for Finance & Control and Human Resources. ESM Secretary General Kalin Anev Janse, who was in charge of these two latter divisions, takes charge of Funding and Asset Liability Management (ALM) & Lending. He remains in charge of Corporate Governance & Internal Policies as well as IT & Operations. As part of these changes, Mr Anev Janse's title changes to Member of the Management Board, Funding, ALM & Lending and Secretary General. Mr Frankel's title remains Deputy Managing Director and Chief Financial Officer. The responsibilities of the other Management Board remained unchanged.

Management Board and Heads of Division

- In 2015, the ESM reached a total of 156 staff, secondees, trainees and interims at year-end. It is set to grow to a final headcount of 169, excluding trainees and interims, in 2016.
- Economics and communications launched two new papers series: scholarly working papers and discussion papers on topics related to the ESM mandate.
- In 2015, the ESM completed the establishment of a comprehensive system of internal controls as mandated by the Board of Directors.
- The ESM introduced non-euro instruments to diversify its investment portfolio.
- The ESM is working on extending its office, information technology (IT) systems and IT governance to accommodate growing operational needs.

Funding, Asset Liability Management & Lending, and Secretary General

The Funding, ALM & Lending, and Secretary General department consists of four areas:

The Funding division is responsible for raising funds on the capital market to enable the ESM to provide financing to beneficiary Members. Furthermore, the division maintains the relationships with banks, investors, issuers, and other capital market participants.

The ALM & Lending division oversees the full balance sheet of the ESM. It also structures, co-negotiates, and implements the financial assistance facilities. In addition, it monitors and manages structural risks, such as those related to interest rates, currency or liquidity, and performs the institution's cash management function.

The Corporate Governance and Internal Policies division manages shareholder relations with the ESM Members, and prepares the meetings of the ESM Board of Governors, Board of Directors, as well as the Board of Auditors. It also develops ESM internal policies and coordinates the ESM Internal Control Framework and its Business Continuity Planning. In addition, the division includes the Procurement Function and acts as the central ESM Project Management Office.

IT and Operations is responsible for supporting all Information Technology, infrastructure, and facilities management services required for the success of the ESM's daily activities. The division supports all ESM applications, manages service providers, IT risks, IT internal controls, IT Governance and Security.

Finance

The Finance department consists of three areas:

Finance and Control develops and maintains the ESM accounting policies, monitors and reports on the ESM financial position, and maintains effective internal controls over the preparation, integrity, and fair presentation of the ESM Financial Statements.

The Investment and Treasury division manages the paid-in capital and implements the ESM Investment Policy.

The Human Resources division is responsible for ensuring that the ESM is able to attract and retain high-quality staff while fostering a diverse workforce within an inspiring, supportive and productive work environment. It works closely with the business areas to promote a learning and development culture and tailor working conditions and compensation and benefits to make the ESM an employer of choice. To ensure compliance with applicable laws and promote staff safety and well-being in the workplace, it develops best practice policies, such as performance management practices, grievance procedures and employee assistance programmes.

Middle & Back Office and Coordination

The Middle & Back Office department ensures that all ESM financial transactions are adequately booked, settled, controlled, and reported. It also plays a front-end role in monitoring risks, including counterparty, settlement, and operational risks.

In addition the department fulfils an internal coordination role throughout the whole institution.

Economics, Policy Strategy and Banking

The Economics, Policy Strategy and Banking department develops, assesses, and reviews the ESM's policy strategy, financial architecture, and financial assistance instruments. It analyses the general macroeconomic environment and the functioning of the financial markets, specifically in relation to sovereign debt. In addition, it develops the Early Warning System reports on macroeconomic and credit risks in programme countries, develops and maintains credit risk assessment for the ESM investment strategy, and coordinates the ESM's activity with the EU and international institutions.

Furthermore, it monitors and analyses the euro area banking system and those banks supervised by the Single Supervisory Mechanism. It also participates in financial sector-related programme work in countries benefitting from ESM financial assistance.

Legal

The Legal department provides expert legal support and legal documentation to the ESM and manages the legal risks arising from the institution's unique mandate. It works closely with all other departments to preserve the ESM's interests, provide an effective contribution to ESM strategy with respect to the integrity of the business, mitigate legal risks that may result from ESM business activities, and provide legal advice regarding ESM activities and operations. The department also manages corporate legal structures and matters, provides transaction support, and is involved in the review of new products.

Risk and Compliance

The Risk function acts as the ESM's central independent risk oversight function, developing and maintaining a regular inventory of risks, identifying, assessing, and proposing mitigating alternatives. It also reports risks in a consistent manner to ESM management and the Board of Directors, setting the limit framework and escalating any limit breaches, and fostering a risk culture throughout the whole organisation. The Compliance function seeks to assist the Managing Director and staff in carrying out the ESM's mission in a manner that stands up to the closest public scrutiny, by implementing a compliance framework which upholds sound and responsible business practices.

Internal Audit

Internal Audit is an independent and objective assurance function that assists the ESM by bringing a systematic and disciplined approach to evaluating and improving the ESM's risk management, internal control, and governance processes. All activities, operations, and processes of the ESM may be subject to internal auditing. Internal Audit reports directly to the Managing Director and has its objectives set in the ESM Internal Audit Charter.

Communications

The Communications department is tasked with explaining to the public, media, and all stakeholders the ESM's mandate and actions. To accomplish this task, the department shapes ESM messages and provides information through all available communication channels: website, social media, publications, visitor groups, interviews, speeches, press conferences, and other public appearances by the Managing Director and the other members of the Management Board.

ESM BOARD DECISIONS

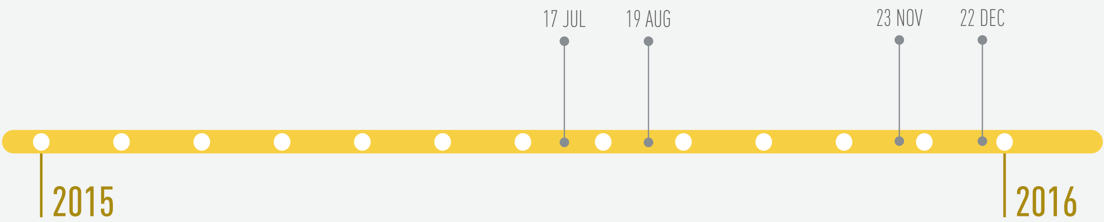
ESM grants Greece loan programme

17 July 2015 – Following a formal request by Greece, the Board of Governors decides to grant, in principle, stability support to Greece of up to €86 billion.

19 August 2015 – After Greece implements a series of pre-programme reforms, the Board of Governors approves the ESM proposal for a loan contract and a reform package agreed with Greece. Greece must show ongoing progress in implementing these reforms to access funds during the three years they are available.

19 August 2015 – Following the Board of Directors' approval of the loan agreement, the Board of Directors also approves the disbursement of the first €26 billion of financial assistance.

23 November and 22 December 2015 – After Greece implements further wide-ranging reforms, the Board of Directors authorises additional disbursements.



Nicola Giammarioli (left), the ESM's Head of Strategy and Institutional Relations and ESM mission chief for Greece, and Declan Costello, the European Commission's mission chief for Greece, at a break during a Eurogroup meeting in May 2016. (Credit: European Union)

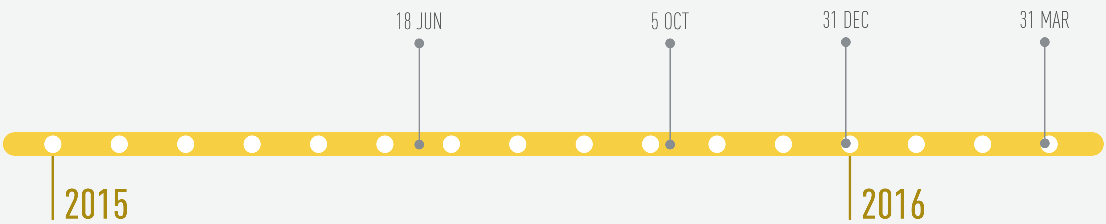
Cyprus exits ESM programme successfully after final disbursements

In return for financial assistance, programme countries must adhere to a strict reform plan, drawn up in a Memorandum of Understanding (MoU). The ESM, together with other institutions (European Commission, European Central Bank and IMF), regularly monitors progress in the implementation of these reforms. After each positive review, the ESM can disburse the next loan instalment.

18 June and 5 October 2015 – Following the sixth and seventh review of Cyprus's reform implementation, the Board of Governors approves updated MoUs. Subsequently, the Board of Directors authorises the disbursements of €100 million and €500 million.

31 December 2015 – At year-end 2015, the ESM had disbursed €6.3 billion out of a maximum of €8.97 billion. No further funds are disbursed.

31 March 2016 – Cyprus exits the programme successfully and on time, without the need for any immediate follow-up assistance.



ESM Board of Directors approves Spain's voluntary early ESM loan repayment

In March and July 2015, Spain voluntarily requests early repayments of €1.5 billion and €2.5 billion of its ESM loans following a similar request in July 2014. The ESM Board of Directors responds favourably. The early Spanish repayments send a positive signal to the markets about the overall attractiveness of the Spanish economy and the success of the ESM programme.

ESM Managing Director Klaus Regling (left) and Spanish Minister of Economy and Competitiveness Luis de Guindos sign the original early repayment in July 2014. (Credit: European Union)

04

FINANCIAL REPORT

The ESM, established to support financially distressed euro area Member States, is not profit driven. It aims to preserve its capital, and it manages its investment portfolios according to prudent and conservative guidelines. The ESM does not have a target for its financial result.

2015 balance sheet

At year-end 2015, the total balance sheet of the ESM was €778.9 billion, an increase of €26.3 billion over the previous year. The increase stems from loan disbursements in 2015 under the new programme for Greece, additional disbursements to Cyprus, and the capital subscription from Lithuania, which became the ESM's 19th member in 2015.

In 2015, loans and advances to euro area Member States increased by €18 billion to €63.4 billion. The ESM disbursed €21.4 billion in loans to Greece and €0.6 billion to Cyprus. The ESM received €4 billion in early repayments from Spain.

To provide loans to the beneficiary Member States, the ESM relies on its funding activity. In 2015, the total liability in respect of debts evidenced by certificates increased by 46% to €72 billion (€49.2 billion in 2014), reflecting increased lending.

Lithuania joined the ESM on 3 February 2015 and subscribed €2.9 billion of capital, of which €0.3 billion was called. Lithuania made the first instalment of €65.4 million for its paid-in shares.

As of 31 December 2015, the total €80.2 billion of paid-in capital (€80 billion of initial subscription increased by the first installments of Lithuania and Latvia) is invested in debt securities and money market instruments or held in cash.

Unrealised gains or losses resulting from the valuation of the securities portfolio are reflected in the fair value reserve within the equity position of the ESM. As of 31 December 2015, the fair value reserve was €127.7 million, down from €512.9 million a year earlier. The variation reflects the realisation of a large part of the previous unrealised gains, while the year-on-year portfolio performance was positive.

2015 profit and loss account

For the financial year 2015, the ESM recorded a net income of €729.4 million, compared to a net income of €443.9 million in 2014. The operating income of the ESM is mainly driven by the interest margin on its lending activity and the return on the investment of the paid-in capital. The distinct elements of the total cost of a loan are defined in the ESM Pricing Policy.

In 2015, the interest income on loans to beneficiary Member States was €483.7 million, while the interest expense on ESM-issued debt securities was €307.7 million. The paid-in capital investments mainly contributed to the result of the ESM. The interest income on the paid-in capital investments fell to €139.2 million from €197.9 million in 2014, while the net realised income from sales of debt securities rose to €438.7 million from €102.9 million.

Operating costs including depreciation of fixed assets were €50 million, compared to €41.7 million in 2014. The increase stemmed principally from additional staff and related overhead costs, and the strengthening of the internal control environment. The ESM provides certain administrative services to the EFSF and charged it related fees of €24.6 million in 2015, which are recognised as Other operating income. The ESM continues to focus on budgetary discipline and effective cost control.

Outlook for 2016

The ESM has actively diversified its investments and continues to look for additional measures to mitigate the impact of negative yields, in line with its guidelines and its mandate. Nevertheless, the current market environment is likely to affect the performance of ESM's portfolios and generate lower returns in 2016. To support its 2016 programmes, the ESM has a funding target of €28.5 billion.

Balance sheet

As at 31 December 2015 (in €'000)

	Notes	31.12.2015	31.12.2014
ASSETS			
Cash in hand, balances with central banks and post office banks	5	54,831,051	4,388,003
Loans and advances to credit institutions			
(a) other loans and advances	6	186,514	18,656,514
		186,514	18,656,514
Loans and advances to euro area Member States	7	63,445,582	45,421,460
Debt securities including fixed-income securities	8		
(a) issued by public bodies		27,105,429	55,518,169
(b) issued by other borrowers		8,329,546	6,132,255
		35,434,975	61,650,424
Intangible assets	9	25	86
Tangible assets	10	2,923	3,447
Subscribed capital unpaid	2.14/15	624,250,300	621,714,100
Subscribed capital called but not paid	2.14/15	394,480	176,960
Prepayments and accrued income	11	318,005	595,061
Total assets		778,863,855	752,606,055
LIABILITIES			
Debts evidenced by certificates	12		
(a) debt securities in issue		72,054,845	49,163,608
		72,054,845	49,163,608
Other liabilities	13	9,771	23,591
Accruals and deferred income	14	446,135	273,367
Total liabilities		72,510,751	49,460,566
SHAREHOLDERS' EQUITY			
Subscribed capital	2.14/15	704,798,700	701,935,300
Fair value reserve	8	127,703	512,863
Reserve fund	2.7.1/16	697,326	253,403
Profit for the financial year		729,375	443,923
Total shareholders' equity		706,353,104	703,145,489
Total equity and liabilities		778,863,855	752,606,055

Off-balance sheet

As at 31 December 2015 (in €'000)

	Notes	31.12.2015	31.12.2014
OFF-BALANCE SHEET			
Commitments	23		
(a) undisbursed loans to euro area Member States		67,265,572	3,268,000
		67,265,572	**3,268,000**
Other items	24		
(a) nominal value of currency swap contracts			
- receivable		2,374,954	-
- payable		(2,448,428)	-
(b) nominal value of currency forward contracts			
- receivable		43	-
- payable		(46)	-

Profit and loss account

For the financial year ending 31 December 2015 (in €'000)

	Notes	2015	2014
Interest receivable and similar income			
(a) on cash and cash equivalents		-	1
(b) on loans and advances to credit institutions		1,603	23,002
(c) on loans and advances to euro area Member States	17	483,717	499,608
(d) on debt securities including fixed-income securities	18	137,638	187,474
(e) other	24.1	1,297	-
		624,255	**710,085**
Interest payable and similar charges			
(a) on debts issued		(307,683)	(348,662)
(b) other	24.1	(559)	-
		(308,242)	**(348,662)**
Commissions payable		**(18)**	**(10)**
Other operating income	19	**24,568**	**21,250**
Net profit on financial operations	20	**438,777**	**102,931**
General administrative expenses			
(a) staff costs	21	(22,453)	(19,148)
- wages and salaries		(16,670)	(13,501)
- social security		(5,783)	(5,647)
of which relating to pension		(4,899)	(4,969)
(b) other administrative expenses	22	(26,666)	(21,761)
		(49,119)	**(40,909)**
Value adjustments in respect of intangible and tangible assets		**(846)**	**(762)**
Profit for the financial year		**729,375**	**443,923**

Statement of changes in equity

For the financial year ending 31 December 2015 (in €'000)

	Subscribed capital	Fair value reserve	Reserve fund	Profit/loss brought forward	Profit for the financial year	Total
At 1 January 2014	**700,000,000**	**(115,716)**	**-**	**(498)**	**253,901**	**700,137,687**
Subscription of capital	1,935,300	-	-	-	-	**1,935,300**
Allocation of the profit of 2013	-	-	-	253,901	(253,901)	**-**
Allocation of profit brought forward to the reserve fund	-	-	253,403	(253,403)	-	**-**
Profit for the financial year	-	-	-	-	443,923	**443,923**
Fair value reserve	-	628,579	-	-	-	**628,579**
At 31 December 2014	**701,935,300**	**512,863**	**253,403**	**-**	**443,923**	**703,145,489**

	Subscribed capital	Fair value reserve	Reserve fund	Profit/loss brought forward	Profit for the financial year	Total
At 1 January 2015	**701,935,300**	**512,863**	**253,403**	**-**	**443,923**	**703,145,489**
Subscription of capital	2,863,400	-	-	-	-	**2,863,400**
Allocation of the profit of 2014	-	-	-	443,923	(443,923)	**-**
Allocation of profit brought forward to the reserve fund	-	-	443,923	(443,923)	-	**-**
Profit for the financial year	-	-	-	-	729,375	**729,375**
Fair value reserve	-	(385,160)	-	-	-	**(385,160)**
At 31 December 2015	**704,798,700**	**127,703**	**697,326**	**-**	**729,375**	**706,353,104**

Statement of cash flows

For the financial year ending 31 December 2015 (in €'000)

	2015	2014
Cash flows from operating activities:		
Profit for the financial year	729,375	443,923
Adjustments for:		
Value adjustments in respect of tangible and intangible assets	846	762
Changes in:		
Tangible and intangible assets	(261)	(1,223)
Other liabilities	(13,820)	760
Accrued interest and interest received	(1,130,970)	(1,217,211)
Prepayments	65,067	(54,115)
Accruals and deferred income and interest paid	356,850	301,433
Out of which:		
Interest received	1,342,959	1,136,919
Up-front service fee received	110,128	5,500
Interest paid	(294,210)	(262,678)
Net cash provided by operating activities	**1,165,964**	**354,070**
Cash flows from investing activities		
Change in debt securities including fixed-income securities	25,830,289	(10,660,070)
Change in loans and advances to credit institutions	18,470,000	4,320,000
Net loans disbursed during the year	(18,024,122)	511,540
Net cash provided/used in investing activities	**26,276,167**	**(5,828,530)**
Cash flows from financing activities		
Payment of capital	109,680	15,756,656
Changes in debt securities in issue	22,891,237	(10,862,833)
Net cash provided by financing activities	**23,000,917**	**4,893,823**
Net increase/decrease in cash and cash equivalents	50,443,048	(580,637)
Cash and cash equivalents at the beginning of the financial year	4,388,003	4,968,640
Cash and cash equivalents at the end of the financial year	**54,831,051**	**4,388,003**

Notes to the financial statements

1. General information

The **European Stability Mechanism** ("ESM") was inaugurated on 8 October 2012 and established as an international financial institution with its registered office at 6a, Circuit de la Foire Internationale, L-1347 Luxembourg, Grand Duchy of Luxembourg.

The finance ministers of the then 17 euro area countries signed a first version of a Treaty establishing the European Stability Mechanism on 11 July 2011. A modified version, incorporating amendments aimed at improving the ESM's effectiveness, was signed in Brussels on 2 February 2012 (ESM Treaty). The ESM Treaty entered into force on 27 September 2012 and the ESM was inaugurated on 8 October 2012 following ratification by the then 17 euro area Member States.

Latvia joined the euro area on 1 January 2014. The Latvian parliament approved the ESM Treaty on 30 January 2014, and Latvia officially became the ESM's 18th Member on 13 March 2014. The ESM Treaty was amended.

Lithuania joined the euro area on 1 January 2015. The Lithuanian parliament approved the ESM Treaty on 18 December 2014, and Lithuania officially became the ESM's 19th Member on 3 February 2015. The ESM Treaty was amended.

The present financial statements cover the period from 1 January 2015 to 31 December 2015, while comparative figures cover the period from 1 January 2014 to 31 December 2014.

On a proposal from the Managing Director, the Board of Directors adopted the financial statements on 18 March 2016 and authorised their submission to the Board of Governors for approval at their 16 June 2016 meeting.

1.1. General overview of the financial assistance programmes

The ESM is authorised to use the following lending instruments for the benefit of its Members, subject to appropriate conditionality:

- grant financial assistance in the form of loans to an ESM Member (ESM Shareholder) in the framework of a macroeconomic adjustment programme;
- purchase bonds or other debt securities in the primary debt market and conduct operations on the secondary debt market in relation to the bonds of an ESM Member;
- grant precautionary financial assistance to ESM Members in the form of credit lines;
- provide financial assistance for the recapitalisation of financial institutions through loans to ESM Members' governments;
- recapitalise systemic and viable euro area credit institutions directly under specific circumstances and as a last resort measure, following the 8 December 2014 ratification of a new instrument, the Direct Recapitalisation of Institutions.

1.2. Overview of the pricing structure of the financial assistance programmes

The total cost of financial assistance to a beneficiary Member State is an aggregate of several distinct elements that are established in the ESM Pricing Policy:

- Base rate – the cost of funding incurred by the ESM, derived from a daily computation of the actual interest accrued on all bonds, bills, and other funding instruments issued by the ESM.
- Commitment fee – the negative carry and issuance costs incurred in the period between the funding by the ESM and the disbursement to the beneficiary Member State, or for the period from the refinancing of the relevant funding instrument until its maturity. The commitment fee will be applied ex-post on the basis of the negative carry actually incurred.
- Service fee – the source of general revenues and resources to cover the ESM's operational costs. The service fee has two components:
    - up-front service fee (50 bps) generally deducted from the drawn amount,
    - annual service fee (0.5 bps) paid on the interest payment date.
- Margin – paid on the interest payment date. The margin charged differs across financial support instruments.
    - 10 bps for loans and primary market support facilities;
    - 5 bps for secondary market support facilities;
    - 35 bps for precautionary financial assistance;
    - 30 bps for financial assistance provided to an ESM Member for the recapitalisation of its financial institutions.

In addition, the ESM Pricing Policy includes specific elements tied to financial assistance for the Direct Recapitalisation of Institutions.

Penalty interest may be applied to overdue amounts, which corresponds to a charge of 200 bps over the higher of either the Euribor rate applicable to the relevant period selected by the ESM or the interest rate which would have been payable.

1.3. ESM financial assistance to Spain

The Eurogroup, composed of the finance ministers of the euro area countries, reached political agreement on 20 July 2012 that financial assistance should be granted to Spain for the recapitalisation of its banking sector, following an official request from the Spanish government. The financial assistance was designed to cover the estimated capital requirements along with an additional safety margin, amounting to €100 billion. The loans were provided to Spain's bank recapitalisation fund, Fondo de Restructuración Ordenado Bancaria (FROB), and then channelled to the relevant financial institutions. The assistance was initially committed under a European Financial Stability Facility (EFSF) programme. On 28 November 2012, the ESM Board of Governors decided the ESM would assume this commitment, in line with Article 40(1) and (2) of the ESM Treaty.

This was the ESM's first financial assistance programme. It was also the first use of the instrument for recapitalising banks through loans granted to a government. No other lenders contributed.

On 3 December 2012, the Spanish government formally requested the disbursement of €39.5 billion in funds. On 5 December 2012, the ESM launched and priced notes, which were transferred to the FROB on 11 December 2012. The FROB used the notes in the amount of €37 billion for the recapitalisation of the following banks: BFA-Bankia, Catalunya-Caixa, NCG Banco, and Banco de Valencia. The FROB also provided €2.5 billion to Sareb, the asset management company, for assets arising from bank restructuring.

The Spanish government formally requested a second disbursement of €1.8 billion for the recapitalisation of Banco Mare Nostrum, Banco Ceiss, Caja 3 and Liberbank on 28 January 2013. The ESM subsequently transferred the funds in the form of ESM notes to the FROB on 5 February 2013.

The ESM financial assistance programme expired on 31 December 2013. In total, the ESM disbursed €41.3 billion to Spain to recapitalise the banking sector. The remaining undisbursed amount of the facility was cancelled.

On 7 July 2014 the ESM Board of Directors approved Spain's request to make a early repayment of €1.3 billion of its loan. This was the first time that a euro area country under a financial assistance programme made an early repayment request. The repayment took place on 8 July 2014 and was accompanied by a scheduled repayment of unused funds of €0.3 billion on 23 July 2014. Both repayments were made in cash.

The ESM received two further early repayment requests from the Spanish authorities in 2015. The authorities submitted the first request on 27 February 2015. The ESM Board of Directors approved this €1.5 billion early repayment request on 9 March 2015 and the repayment took place on 17 March 2015. On 2 July 2015, the ESM Board of Directors approved another early repayment request from the Spanish government. This €2.5 billion repayment took place on 14 July 2015. Both 2015 repayments were made in cash.

1.4. ESM financial assistance to Cyprus

The Cypriot Government requested stability support on 25 June 2012. In response, the Eurogroup agreed the key elements of a macroeconomic adjustment programme on 25 March 2013.

The agreement on the macroeconomic adjustment programme led euro area members to decide on a financial assistance package of up to €10 billion. On 24 April 2013, the ESM Board of Governors decided to grant stability support to Cyprus. The ESM Board of Directors subsequently approved the Financial Assistance Facility Agreement (FFA) on 8 May 2013. The ESM will provide up to €9 billion, and the International Monetary Fund (IMF) will contribute around €1 billion. The availability period ends on 31 March 2016.

According to the terms of the FFA, the first tranche of financial assistance was provided to Cyprus in two separate disbursements: the ESM disbursed the first €2 billion on 13 May 2013, and transferred the second in the amount of €1 billion on 26 June 2013. The second tranche of assistance, €1.5 billion of ESM floating rate notes, was disbursed on 27 September 2013. The Cypriot government used the notes for the recapitalisation of the cooperative banking sector. The third tranche of assistance, €0.1 billion, was disbursed on 19 December 2013. Disbursements of a total of €1.1 billion were made in 2014, and €0.6 billion in 2015.

The financial assistance facility is designed to cover Cyprus's financing needs after including proceeds from burden-sharing measures that the Cypriot government adopted for the banking sector. These needs include budgetary financing, the redemption of medium- and long-term debt, and the recapitalisation of financial institutions. They exclude the country's two largest banks, Bank of Cyprus and Cyprus Popular Bank, which the Cypriot government subjected to restructuring and resolution measures.

1.5. ESM financial assistance to Greece

The EFSF financial assistance programme for Greece expired on 30 June 2015. On 8 July 2015, the Greek government submitted a request for financial assistance to the Chairperson of the ESM Board of Governors. On 13 July 2015, the euro area ministers of finance agreed with Greece a set of urgent prior actions in order to start negotiations for a new programme under the ESM. The ESM Board of Governors finally approved a new programme on 19 August 2015. The programme focuses on four key areas: restoring fiscal sustainability, safeguarding financial stability, boosting growth, competitiveness and investment, and reforming the public administration.

At the same time, the ESM Boards of Governors and Directors approved the financial assistance facility agreement (FFA) with Greece on 19 August 2015. The ESM will provide Greece with up to €86 billion in financial assistance over three years. The precise amount of ESM financial assistance will depend on IMF's participation in the programme and on the success of reform measures by Greece.

The funds available under the FFA are earmarked to cover needs related to debt servicing, banking sector recapitalisation and resolution and budget financing. To return its economy to growth and make its debt burden more sustainable, the Greek government has committed to a series of far-reaching economic reforms.

On 20 August 2015, the ESM approved the first tranche of €26 billion financial assistance for Greece, divided in two sub-tranches. This decision followed the ESM Board of Directors' approval of the FFA, specifying the terms of the financial assistance. The Board of Directors also decided to immediately disburse €13 billion in cash to Greece. This was the first disbursement under the first sub-tranche, of €16 billion, to be used for budget financing and debt servicing needs. The second sub-tranche, of €10 billion, was immediately created in ESM floating rate notes and held in a segregated account. These funds were designated to cover the Greek banking sector's potential resolution and recapitalisation costs, with release decisions to be taken on a case-by-case basis.

On 23 November 2015, the Board of Directors authorised the disbursement of €2 billion in cash to Greece as the second disbursement under the €16 billion sub-tranche approved in August 2015. This decision followed the Greek government's completion of the first set of reform milestones. This disbursement was primarily used for debt servicing.

On 1 December 2015, the Board of Directors decided to release €2.7 billion to Greece to recapitalise Piraeus Bank. Subsequently, on 8 December 2015, the Board of Directors decided to release €2.7 billion to Greece to recapitalise the National Bank of Greece. The ESM transferred these amounts under the €10 billion sub-tranche, held in ESM notes in a segregated account. The availability period of the remaining €4.6 billion expires on 31 January 2016.

On 22 December 2015, the Board of Directors approved the disbursement of €1 billion to Greece as the third and final disbursement under the €16 billion sub-tranche agreed in August 2015. This decision followed the Greek government's completion of the second set of reform milestones. This disbursement was also used for debt servicing.

2. Summary of significant accounting policies

The principal accounting policies applied in the preparation of these financial statements are set out below.

2.1. Basis of presentation

The accompanying financial statements are prepared and presented in accordance with the Directive 86/635/EEC of the Council of the European Communities of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions, as amended by Directive 2001/65/EC of 27 September 2001, by Directive 2003/51/EC of 18 June 2003 and by Directive 2006/46/EC of 14 June 2006 (the 'Directives'). Their specific application by the ESM is described in the subsequent notes. Directive 2006/46/EC has been amended by Directive 2013/34/EU. The ESM applies the same transitional period as that applicable to the Member States for transposition by 2016.

The ESM prepares an Activity Report ('description of policies and activities') that is presented separately from the financial statements.

The preparation of financial statements in conformity with the Directives requires the use of certain critical accounting estimates. It also requires Management[14] to exercise its judgement in applying the ESM's accounting policies. Areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the financial statements, are disclosed in Note 2.3.

2.2. Basis of measurement

The accompanying financial statements are prepared on a historical cost basis, except for the loans and advances to euro area Member States and the debts evidenced by certificates which are measured at amortised cost, and the paid-in capital and reserve fund investments which are measured at fair value with gains and losses recognised in the fair value reserve.

2.3. Use of estimates

In preparing the financial statements, Management is required to make estimates and assumptions that affect reported income, expenses, assets, liabilities, and the disclosure of contingent assets and liabilities. The use of available information and application of judgement are inherent to the formation of estimates. Actual results in the future could differ from such estimates and the resulting differences may be material to the financial statements. Any revision to accounting estimates is recognised prospectively in current and future periods.

The ESM is entitled to charge 50 bps of up-front service and 0.5 bps annual service fees to the beneficiary Member States, to cover the ESM's operational cost, as Note 1.2 describes. The ESM recognises the up-front service fees over a seven-year period, to reflect the expected occurrences of the expenses that it aims to cover.

The ESM reviews its loans and advances to euro area beneficiary Member States at each reporting date, to assess whether a value adjustment is required (see also Note 2.8). Such assessment requires judgement by the Management and the ESM governing bodies, consistent with the ESM's mandate as a permanent crisis resolution mechanism that aims at supporting beneficiary Member States' return to public financial stability.

No value adjustment was required as at 31 December 2015 and 2014, thus none has been recorded.

2.4. Foreign currency translation

The ESM uses the euro (€) as the unit of measure of its accounts and for presenting its financial statements.

Foreign currency transactions are recorded at the rates of exchange prevailing on the date of the transaction. Exchange differences, if any, arising out of transactions settled during the year are recognised in the profit and loss account as 'Net profit or loss on financial operations'.

Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are translated at the closing exchange rates on that date.

Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rates on the dates of the initial transactions. Non-monetary items measured at fair value in a foreign currency are translated using the exchange rates on the date when the fair value was determined.

[14] As per Article 7 (5) of the ESM Treaty the Managing Director shall conduct, under the direction of the Board of Directors, the current business of the ESM; as per Article 21 (1) of the ESM By-Laws the Board of Directors shall keep the accounts of the ESM and draw up its annual accounts.

The exchange differences, if any, are recognised in the profit and loss account and related assets and liabilities are revalued on the balance sheet.

2.5. Derivative financial instruments

The ESM uses derivatives for risk management purposes only. Derivative transactions such as currency swaps and forward contracts are used to hedge the currency risk into euro[15] (refer to Note 3.3.2).

All derivatives transactions are booked at nominal as off-balance sheet items at the date of the transaction.

2.5.1. Currency swaps and currency forward contracts

The ESM enters into currency swap and currency forward contracts in order to cover currency positions in its paid-in capital portfolio. Ongoing forward and spot exchange transactions are converted at the spot rates of exchange prevailing on the balance sheet date and neutralised in 'Accruals and deferred income' or 'Prepayments and accrued income'. The spread between the spot amount and forward settlement amount is linearly amortised through the profit and loss account in 'Interest receivable and similar income' or 'Interest payable and similar charges'.

2.6. Cash in hand, balances with central banks and post office banks

Cash in hand and balances with central banks and post office banks include cash in hand, demand deposits and other short-term highly liquid investments with original maturities of three months or less. Bank overdrafts, if any, are shown within borrowings in current liabilities on the balance sheet.

2.7. Debt securities including fixed-income securities

The ESM has established the following portfolio categories to clarify the management of its financial assets:

2.7.1. Paid-in capital and reserve fund investments

The ESM's capital provisions are laid down in Chapter 3 of the ESM Treaty. The initial aggregate nominal value of paid-in shares was €80 billion and has been increased to €80.5 billion due to the accession of Latvia and Lithuania. The net income generated by ESM operations and the proceeds of the financial sanctions received from the ESM Members under the multilateral surveillance procedure, the excessive deficit procedure, and the macro-economic imbalances procedure established under the Treaty on the Functioning of the European Union (TFEU) are put aside in a reserve fund, in accordance with Chapter 5 of the ESM Treaty.

The paid-in capital and the reserve fund are invested in accordance with the Guidelines on Investment Policy approved by the Board of Directors. The main objective of such investments is to ensure that the maximum lending volume is always readily available, and to absorb potential losses.

According to the investment principles defined in the Guidelines on Investment Policy an appropriate level of diversification of the Investment Portfolios shall be maintained to reduce the ESM's overall risk. Diversification shall be attained through allocation between various asset classes, geographical areas (and notably supranational institutions, and issuers outside the euro area), issuers, and instruments.

According to the Guidelines on Investment Policy, any currency risk shall be hedged into euro to ensure a limited remaining foreign exchange risk for the ESM. Derivatives shall be used for risk management purposes only.

[15] As per Article 2 (5) of the ESM Guidelines on the Investment Policy, any currency risk shall be hedged into euro to ensure a limited remaining foreign exchange risk for the ESM.

The paid-in capital and the reserve fund investments are managed in different portfolios. As the Guidelines on Investment Policy specifies, the paid-in capital is divided in two tranches:

Short-term tranche

The tranche with the highest liquidity requirements is the short-term tranche. The main objective of the short-term tranche is to enable the ESM to face any temporary disbursement to cover any shortfall, due to a non-payment by a beneficiary Member State. "This tranche is invested in liquid investment instruments with a capital preservation objective at a one-year horizon, with a high level of confidence.

Medium- and long-term tranche

The main objective of the medium- and long-term tranche is to ensure the ESM's financial strength. This tranche is managed to enhance the return of the paid-in capital and is subject to the constraints specified in the investment guidelines. This tranche is also mainly invested in liquid investment instruments.

The reserve fund, which is drawn from income generated by ESM operations, has the same requirements and purposes as the short-term tranche. Consequently, it follows the same investment guidelines.

The paid-in capital and the reserve fund investments are initially recognised at fair value including any transaction costs, and measured subsequently at fair value with gains and losses recognised in the fair value reserve, except for impairment losses and foreign exchange gains and losses, until the financial asset is derecognised. Unrealised gains or losses are accumulated in the fair value reserve until such investment is sold, collected or otherwise disposed of, or until such investment is determined to be impaired.

If such financial asset is determined to be impaired, the cumulative gain or loss previously recognised in the 'Fair value reserve' is recognised in the profit and loss account. Interest, however, is recognised on a straight-line basis.

2.7.2. Liquidity buffer investments

The ESM's borrowing strategy must meet several objectives and principles to comply with the purpose established in Article 3 of the ESM Treaty. The general borrowing strategy must therefore offer the possibility to react rapidly to unexpected market developments, including the build-up of liquidity buffers during periods of systemic risk and ensure market access, even in a difficult market environment.

The liquidity buffer is invested in accordance with the Guidelines on Investment Policy for the short-term tranche of the paid-in capital described in Note 2.7.1.

2.7.3. Fee investments

The ESM invested the service fees and the margin collected from ESM operations into deposits and short-term highly rated debt securities. The fee investment portfolio is invested following the same investment guidelines as for the short-term tranche of the paid-in capital described in Note 2.7.1.

2.7.4. Determination of fair value

For financial instruments traded in active markets, the determination of fair values for financial assets and financial liabilities is based on quoted market prices or dealer price quotations.

A financial instrument is considered to be trading in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis.

Where the fair values of financial instruments recorded on the balance sheet cannot be derived from active markets, they are determined using valuation techniques that include the use of mathematical models. The chosen valuation techniques incorporate factors that market participants would take into account in pricing a transaction and are based whenever possible on observable market data. If such data is not available, a degree of judgement is required in establishing fair values.

2.8. Loans and advances to credit institutions and to euro area Member States

Loans and advances are non-derivative financial assets with fixed or determinable payments that are not traded on an active market. Loans and advances are initially recognised at their net disbursement amounts, and subsequently measured at amortised cost.

Transaction costs and premiums/discounts are amortised in the profit and loss account through interest receivable and similar income. Interest income on loans and advances to credit institutions and to euro area Member States are also included in 'Interest receivable and similar income' in the profit and loss account.

Specific value adjustments are accounted for in the profit and loss account in respect of loans and advances presenting objective evidence that all or part of their outstanding balance is not recoverable (refer to Note 2.3) and are deducted from the corresponding asset in the balance sheet.

2.9. Intangible assets

Intangible assets are recorded on the balance sheet at their acquisition cost, less accumulated amortisation. Amortisation is calculated on a straight-line basis over the estimated life of each item purchased. Intangible assets comprise computer software that are amortised within three years.

2.10. Tangible assets

Tangible assets are recorded on the balance sheet at their acquisition cost, less accumulated depreciation.

Depreciation is calculated on a straight-line basis over the estimated life of each item purchased, as set out below:

- permanent equipment, fixtures and fittings: nine years or until the end of building rent period;
- furniture and office equipment: five years;
- IT equipment: three years.

If works performed on leased properties are capitalised (as fixture and fittings) then the estimated life of those assets should not exceed the duration of the lease agreement.

2.11. Prepayments and accrued income

Prepayments and accrued income are related either to invoices received and paid in advance for expenses related to subsequent reporting periods, or to any income related to the reporting period which will only be received in the course of a subsequent financial year. It also includes the spot revaluation and spread amortisation of ongoing derivative transactions (refer to Note 2.5.1).

2.12. Debts evidenced by certificates

Debts evidenced by certificates are presented at their amortised cost. Transaction costs and premiums/discounts are amortised in the profit and loss account through 'Interest payable and similar charges'. Interest expenses on debt instruments are also included in 'Interest payable and similar charges' in the profit and loss account.

2.13. Provisions

Provisions are intended to cover liabilities the nature of which are clearly defined and which at the date of the balance sheet are either likely to be incurred, or certain to be incurred but uncertain as to the amount or as to the date on which they will arise.

Where there are similar obligations, the likelihood that an outflow will be required in settlement is determined by considering the class of obligations as a whole.

2.14. Subscribed capital

On 31 December 2015, the ESM's shareholders were the 19 euro area Member States. In accordance with Article 8 of the ESM Treaty, the authorised capital is €704.8 billion, which is divided into 7,047,987 shares, with a nominal value of €100,000 each. The authorised capital was subscribed by the shareholders according to the contribution key provided in Article 11 and calculated in Annex I of the ESM Treaty. The authorised capital is divided into paid-in shares and callable shares, where the total aggregate nominal value of paid-in shares is €80.5 billion.

In accordance with Article 4 of Directive 86/635/EEC as amended, the authorised capital stock of €704.8 billion is recognised in equity as subscribed capital. The callable shares are presented as 'Subscribed capital unpaid' on the asset side of the balance sheet. Called capital not yet paid by the shareholders is recognised on the asset side of the balance sheet as 'Subscribed capital called but not paid'.

2.15. Accruals and deferred income

Accruals and deferred income are related to payments received before the balance sheet date but not exclusively related to the reporting period, together with any charges which, though relating to the financial year in question will only be paid in a subsequent financial year. It also includes the spot revaluation and spread amortisation of ongoing derivative transactions (refer to Note 2.5.1).

2.16. Interest receivable and payable

Interest income and expenses for all interest-bearing financial instruments are recognised within 'Interest receivable and similar income' and 'Interest payable and similar charges' in the profit and loss account on an accrual basis.

Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

On the balance sheet, accrued interest receivable is included in 'Prepayments and accrued income' under assets while accrued interest payable is included in 'Accruals and deferred income' under liabilities.

2.17. Employee benefits

The ESM operates a pension plan with defined contribution characteristics funded through payments to an external insurance company. This insurance scheme also covers the risk of death and disability.

The pension plan is funded by contributions from the ESM (employer) as well as from employees. The plan is accounted for as a defined contribution plan and corresponding payments are recognised as employee benefit expenses as they fall due.

2.18. Taxation

Within the scope of its official activities, the ESM, its assets, income, property and its operations and transactions shall be exempt from all direct taxes under Article 36 of the ESM Treaty. ESM Members have agreed to remit or refund all indirect taxation, subject to certain exceptions, under the same provision of the ESM Treaty.

3. Risk management

This section presents information about the approach of the ESM to risk management and risk controls and its risk exposure, in relation to the primary risks associated with its use of financial instruments. These are:

- credit risk,
- market risk,
- liquidity and funding risk, and
- operational risk.

Given the nature of the ESM's mandate, where credit risk from lending arises as a result of activities performed in support of beneficiary Member States under a FFA, the credit risk in the ESM's lending exposure must be accepted.

3.1. Risk management organisation

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

According to the ESM's High Level Principles for Risk Management, the targeted risk appetite should preserve the ESM's funding capacity, ensure the highest creditworthiness, and avoid unexpected capital calls. The Risk Policy describes the risk appetite and the framework for identifying, assessing, monitoring and managing risks consistent with risk appetite. It covers all ESM financial and non-financial risks, and both on- and, if applicable, off-balance sheet items. The risk profile is defined by a set of limits to curtail all types of risks within the risk appetite. The ESM does not aim at generating profit on financial support granted to beneficiary Member States and does not provide incentives for speculative exposures in its investment portfolio.

Departments and business functions assume direct responsibility for day-to-day risk management. All staff are responsible for ensuring that risks relating to their operations are identified, followed up, and reported to the Risk Department. The Risk Department exercises central oversight of risk and ensures that all business functions comprehensively and consistently implement the risk management framework.

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

The Chief Risk Officer is the head of the Risk Department and is a direct report of the Managing Director. The Chief Risk Officer is responsible and accountable for informing the Managing Director on all risks which the institution may face to ensure enforcement and oversight. The Managing Director, as Chairman of the Board of Directors, reports risk-related information to the Board of Directors, principally through the Board Risk Committee.

To support the implementation of the ESM's risk policies, an Internal Risk Committee (IRC) has been created. The IRC translates the risk appetite into the internal limit structure, which is described in the Risk Policy approved by the Board of Directors. The IRC assists the Board of Directors in ensuring the adequacy of the ESM's internal limit structure and limit setting, providing recommendations on changes to the internal limit structure, on the identification of relevant risks, and on the suitability of methods to monitor and manage them. The IRC conducts on a periodical basis a risk self-assessment and reports the result to the Managing Director.

3.2. Credit risk

Credit risk is defined as the potential for loss arising from the 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 which derives from 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 that derives from investment in securities of the paid-in capital and excess liquidity.

Given the ESM's mandate, the ESM risk function does not manage or mitigate the inherent risk of a beneficiary Member State non-payment of loans. We therefore refer to Note 4 below which further describes the treatment of loans to euro area Member States.

3.2.1. Maximum exposure to credit risk without taking into account any collateral or other credit enhancements

The following table shows the maximum exposure to credit risk for the components of the balance sheet without taking into account any collateral or other credit enhancements. For on-balance-sheet positions, these exposures are based on net carrying amounts as reported on the balance sheet.

(in €'000)	Maximum exposure 31.12.2015	Maximum exposure 31.12.2014
Cash in hand, balances with central banks and post office banks	54,831,051	4,388,003
Loans and advances to credit institutions	186,514	18,656,514
Debt securities including fixed-income securities	35,434,975	61,650,424
On balance sheet credit risk exposure	**90,452,540**	**84,694,941**
Off balance sheet items	2,374,997	-
Maximum credit risk exposure	**92,827,537**	**84,694,941**

This table does not include the loans and advances to euro area Member States, as the ESM Risk function does not manage the inherent risk of non-payment of the beneficiary Member States, as described in Note 3.2.

3.2.2. Risk profile of counterparties and issuers

The following tables show the breakdown of the financial assets by credit rating. For 'Debt securities including fixed-income securities', the credit ratings of individual issuances (or in the case of short-term securities their long-term rating equivalents) are presented. If issuance ratings are unavailable, the issuers rating is presented. For other financial assets, the credit ratings of the counterparties are presented.

These tables do not include the breakdown of the 'Loans and advances to euro area Member States', as the ESM risk function does not manage the inherent risk of non-payment of the beneficiary Member States, as described in Note 3.2.

(in €'000)	Credit rating*	Clean carrying value 31.12.2015
Cash in hand, balances with central banks and post office banks	not rated**	54,823,769
	AA+	7,282
Loans and advances to credit institutions	AA+	186,514
Debt securities including fixed-income securities	AAA	20,495,790
	AA+	5,506,167
	AA	6,601,915
	AA-	498,750
	A	2,332,353
Total		**90,452,540**

* Based on the worst rating provided by the major rating agencies (Moody's, Standard & Poor's or Fitch) presented based on the rating scale used by Fitch.
** "Not rated" means balances placed with Eurosystem central banks, which do not have ratings.

(in €'000)	Credit rating*	Clean carrying value 31.12.2014
Cash in hand, balances with central banks and post office banks	not rated**	4,386,627
	AA+	1,376
Loans and advances to credit institutions	not rated**	18,655,000
	AA+	1,514
Debt securities including fixed-income securities	not rated**	2,639,676
	AAA	30,442,526
	AA+	12,337,497
	AA	14,940,124
	AA-	1,290,601
Total		**84,694,941**

* Based on the worst rating provided by the major rating agencies (Moody's, Standard & Poor's or Fitch) presented based on the rating scale used by Fitch.
** "Not rated" means balances placed with Eurosystem central banks and with the Bank for International Settlements, which do not have ratings.

3.2.3. Credit risk on debt securities including fixed-income securities

The ESM invests in assets that fulfil the high credit risk standards the Investment Policy Guideline requires. To mitigate the credit risk on its investments, the ESM has also established a detailed structure of credit limits. The ESM measures credit exposures and monitors limit compliance daily.

3.2.4. Credit risk on derivatives

The credit risk for derivatives lies in the loss which the ESM would incur if a counterparty were unable to honour its contractual obligations.

With regards to derivative transactions, the ESM had only foreign exchange derivative transactions in 2015. On 31 December 2015, all derivative financial instruments had a final maturity of less than one year and all of them were concluded with a euro area central bank or with the Bank for International Settlements. As such, the credit risk on derivatives is negligible and it is aligned to the minimal risk appetite on foreign exchange risk as defined in the Risk Policy.

3.3. Market risk

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risks could arise from open positions in interest rate and currency products, all of which are exposed to general and specific market movements and changes in the volatility of interest and foreign exchange market rates.

3.3.1. Interest rate risk

Interest rate risk is defined as the potential for loss arising from adverse movements in interest rates. The main sources of interest rate risk include asset or liability re-pricing, triggered by covenants or market movements, yield curve shifts, and changes in the funding or lending spread. This risk applies to the paid-in capital investments and may in the future be minimised using interest rate derivatives.

Structural interest rate risk is defined as the risk of a mismatch between the interest rate re-pricing of assets and liabilities on the balance sheet. The current pricing policy for the ESM passes on its cost of funding to beneficiary Member States.

3.3.2. Currency risk

Currency risk is defined as the potential for loss arising from changes in exchange rates and shall be minimised by limiting net exposure to certain currencies.

The ESM is exposed to currency risk whenever there is a currency mismatch between its assets and liabilities. The exclusive source of currency risk is the non-euro investments made in the investment portfolios.

According to the ESM Guideline on Investment Policy, any currency risk shall be hedged into euros to ensure a limited remaining foreign exchange risk for the ESM. The ESM enters into derivative contracts for risk management purposes only.

31 December 2015 (in €'000)	Euro (EUR)	Japanese Yen (JPY)	Danish Krone (DKK)	Other currencies	Total
ASSETS					
Cash in hand, balances with central banks and post office banks	54,831,051	-	-	-	**54,831,051**
Loans and advances to credit institutions	186,514	-	-	-	**186,514**
Loans and advances to euro area Member States	63,445,582	-	-	-	**63,445,582**
Debt securities including fixed-income securities	32,987,538	2,332,353	115,084	-	**35,434,975**
Prepayments and accrued income	315,943	1,430	615	17	**318,005**
Total financial assets	**151,766,628**	**2,333,783**	**115,699**	**17**	**154,216,127**
LIABILITIES					
Debt securities in issue	72,054,845	-	-	-	**72,054,845**
Other liabilities	9,382	-	-	389	**9,771**
Accruals and deferred income	446,101	34	-	-	**446,135**
Total financial liabilities	**72,510,328**	**34**	**-**	**389**	**72,510,751**
Shareholders' equity*	81,708,324	-	-	-	**81,708,324**
Total shareholders' equity**	**81,708,324**	**-**	**-**	**-**	**81,708,324**
Off-balance sheet derivatives	**2,374,996**	**(2,333,103)**	**(115,370)**	**-**	**(73,477)**
Net of financial position	**(77,028)**	**646**	**329**	**(372)**	**(76,425)**

31 December 2014 (in €'000)	Euro (EUR)	Japanese Yen (JPY)	Danish Krone (DKK)	Other currencies	Total
ASSETS					
Cash in hand, balances with central banks and post office banks	4,388,003	-	-	-	**4,388,003**
Loans and advances to credit institutions	18,656,514	-	-	-	**18,656,514**
Loans and advances to euro area Member States	45,421,460	-	-	-	**45,421,460**
Debt securities including fixed-income securities	61,650,424	-	-	-	**61,650,424**
Prepayments and accrued income	595,061	-	-	-	**595,061**
Total financial assets	**130,711,462**	**-**	**-**	**-**	**130,711,462**
LIABILITIES					
Debt securities in issue	49,163,608	-	-	-	**49,163,608**
Other liabilities	23,410	-	-	181	**23,591**
Accruals and deferred income	273,367	-	-	-	**273,367**
Total financial liabilities	**49,460,385**	**-**	**-**	**181**	**49,460,566**
Shareholders' equity*	81,254,429	-	-	-	**81,254,429**
Total shareholders' equity**	**81,254,429**	**-**	**-**	**-**	**81,254,429**
Off-balance sheet derivatives	**-**	**-**	**-**	**-**	
Net of financial position	**(3,352)**	**-**	**-**	**(181)**	**(3,533)**

* Excluding subscribed capital unpaid and subscribed capital called but not paid.

** Shareholder equity has no defined maturity.

3.4. Liquidity risk

The ESM will honour its obligations under its issued debt securities from proceeds that stem from its support programmes, supported by its subscribed capital. The ESM monitors its liquidity position on a daily basis to assess its funding liquidity risk, market liquidity risk, and liquidity concentration risk.

Funding liquidity risk is defined as the inability to raise money in a timely manner. Should such a situation arise, the ESM could be unable to settle obligations in a timely fashion and be held in breach of obligations. Funding liquidity risk is managed by 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.

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 and negatively influencing the market price because of inadequate market depth or market disruption. Market liquidity risk is minimised by investing capital in high-credit-quality liquid assets, ensuring the 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 is minimised by securing credit lines and adopting a diversified funding strategy.

The tables below analyse the ESM's financial assets and liabilities and the shareholders' equity by maturity on the basis of the period remaining between the balance sheet date and the contractual maturity date.

31 December 2015 (in €'000)	Less than 3 months	From 3 months to 1 year	From 1 to 5 years	More than 5 years	Total
ASSETS					
Cash in hand, balances with central banks and post office banks	54,831,051	-	-	-	**54,831,051**
Loans and advances to credit institutions	1,514	185,000	-	-	**186,514**
Loans and advances to euro area Member States	-	-	5,424,122	58,021,460	**63,445,582**
Debt securities including fixed-income securities	2,550,825	2,371,543	19,102,114	11,410,493	**35,434,975**
Prepayments and accrued income	72,248	245,757	-	-	**318,005**
Total financial assets	**57,455,638**	**2,802,300**	**24,526,236**	**69,431,953**	**154,216,127**
LIABILITIES					
Debt securities in issue	13,317,325	9,915,059	30,434,899	18,387,562	**72,054,845**
Other liabilities	9,771	-	-	-	**9,771**
Accruals and deferred income	155,368	97,999	164,776	27,992	**446,135**
Total financial liabilities	**13,482,464**	**10,013,058**	**30,599,675**	**18,415,554**	**72,510,751**
Shareholders' equity*	-	-	-	81,708,324	**81,708,324**
Total shareholders' equity**	**-**	**-**	**-**	**81,708,324**	**81,708,324**
Net of financial position	**43,973,174**	**(7,210,758)**	**(6,073,439)**	**(30,691,925)**	**(2,948)**

31 December 2014 (in €'000)	Less than 3 months	From 3 months to 1 year	From 1 to 5 years	More than 5 years	Total
ASSETS					
Cash in hand, balances with central banks and post office banks	4,388,003	-	-	-	**4,388,003**
Loans and advances to credit institutions	9,656,514	9,000,000	-	-	**18,656,514**
Loans and advances to euro area Member States	-	-	-	45,421,460	**45,421,460**
Debt securities including fixed-income securities	4,315,634	9,031,116	45,066,574	3,237,100	**61,650,424**
Prepayments and accrued income	245,963	349,098	-	-	**595,061**
Total financial assets	**18,606,114**	**18,380,214**	**45,066,574**	**48,658,560**	**130,711,462**
LIABILITIES					
Debt securities in issue	8,428,974	15,832,358	14,946,159	9,956,117	**49,163,608**
Other liabilities	23,591	-	-	-	**23,591**
Accruals and deferred income	77,752	59,603	132,869	3,143	**273,367**
Total financial liabilities	**8,530,317**	**15,891,961**	**15,079,028**	**9,959,260**	**49,460,566**
Shareholders' equity*	-	-	-	81,254,429	**81,254,429**
Total shareholders' equity**	**-**	**-**	**-**	**81,254,429**	**81,254,429**
Net of financial position	**10,075,797**	**2,488,253**	**29,987,546**	**(42,555,129)**	**(3,533)**

* Excluding subscribed capital unpaid and subscribed capital called but not paid.

** The shareholder's equity has no defined maturity.

3.5. Operational risk

Operational risk is defined as the potential loss or damage, and/or the inability of the ESM to fulfil its mandate, resulting from inadequate or failed internal processes, people, and systems or from external events. Operational risks are categorised in line with the guidance by the Basel Committee on Banking Supervision, as follows:

- execution, delivery, and process management;
- counterparts, products, and business practices;
- fraud;
- business continuity and systems failures;
- employment practices and workplace safety; and
- damage to physical assets.

Management has no tolerance for material operational risks, including those originating from third party/vendor engagements, which may result in the ESM's inability to effectively fulfil its mandate, or in significant loss and/or reputational damage. No material operational risk losses were identified in 2015.

All departments are responsible for the proactive mitigation of operational risks, and for the robustness of the controls in their processes. If operational risk events occur, they are reported to the Risk Department through an internal operational risk register. Formal escalation procedures have been established involving the Internal Risk Committee and the Board Risk Committee to ensure the active involvement of senior management and, where necessary, the Board of Directors.

All departments, with support from the Operational Risk function, perform a root-cause analysis of operational risk events and implement improvements, as necessary, in the underlying processes and controls to reduce the probability of reoccurrence. This approach is complemented by annual risk control self-assessments for each department, and an organisation-wide business continuity risk assessment, to identify and assess ESM's top operational risks (based on potential likelihood and impact).The Risk Department monitors these risks and reports on them to the Internal Risk Committee and the Board Risk Committee.

4. Credit risk in relation to loans to euro area Member States

The ESM, as per its mandate, grants financial assistance to euro area Member States experiencing severe financial problems, if indispensable to safeguard the financial stability of the euro area as a whole and of its members. The assistance, therefore, aims at providing financial support according to rules that differ from those of financial markets, given that the overall aim is to support the beneficiary Member State's return to public financial stability.

The determination of debt sustainability and the close monitoring and conditionality attached to all financial assistance to beneficiary Member States, as negotiated with the European Commission in liaison with the European Central Bank (ECB) and whenever possible the IMF, are aimed at addressing and substantially reducing credit risk. It is the mutual understanding of the ESM Members that ESM loans enjoy preferred creditor status that is similar to the IMF, while accepting preferred creditor status of the IMF over the ESM. This does not, however, apply to ESM loans for programmes that existed when the ESM Treaty was signed. Moreover, for the financial assistance to Spain it was decided to not apply the preferred creditor status. The ESM has implemented an early warning procedure as requested by the ESM Treaty to monitor the ability of the beneficiary Member State to repay its obligations.

The ESM provided financial assistance to Spain for the recapitalisation of its financial sector which must be repaid by 2027. It is currently also providing financial assistance to Cyprus, which is implementing a macroeconomic adjustment programme. Furthermore, starting from August 2015, the ESM is providing financial assistance to Greece. Note 7 provides a breakdown of all disbursed amounts, as well as the movements during the year.

From an investor's point of view, the ESM's capital structure and the possibility of capital calls mitigate the risk arising from beneficiary Member States' non-payment and potential losses from other risks. Under Article 9 of the ESM Treaty there are different instances when a capital call can be made to cover losses or avert non-payment, as described in Note 15.

A capital call to replenish paid-in capital can be made to cover any losses in paid-in capital due to a beneficiary Member State non-payment or if losses occurring due to other factors reduce the countervalue of the paid-in capital to below the threshold of 15% of the ESM's maximum lending volume.

Furthermore, an emergency capital call would be made if needed to avoid default of an ESM payment obligation to its creditors.

These mechanisms provide the strongest possible assurance that ESM debt securities will always be serviced and repaid.

5. Cash in hand, balances with central banks and post office banks

The composition of cash in hand, balances with central banks and post office banks is as follows:

(in €'000)	31.12.2015	31.12.2014
Current account balances with euro area central banks	54,823,769	4,386,627
Current account balances with other banks*	7,282	1,376
Total cash in hand, balances with central banks and post office banks	**54,831,051**	**4,388,003**

* The ESM holds current accounts for operational purposes with a state-owned bank as well as clearing accounts with custodians.
No current account is held with post office banks.

6. Loans and advances to credit institutions

The following table shows the breakdown of the other loans and advances to credit institutions:

(in €'000)	31.12.2015	31.12.2014
Money market deposits with euro area central banks	-	18,655,000
Money market deposits with other banks	185,000	-
Other deposits	1,514	1,514
Total loans and advances to credit institutions	**186,514**	**18,656,514**

Other deposits consist entirely of the lease guarantee deposit in relation to the ESM rental agreement.

7. Loans and advances to euro area Member States

The following table shows the geographical breakdown of loans per financial assistance programme and by borrowing country:

(in €'000)	No. of loans	Nominal amount	Clean carrying value: 31 December 2015
Loans to euro area Member States			
- to Spain	5	35,721,460	35,721,460
- to Cyprus	9	6,300,000	6,300,000
- to Greece	5	21,402,428	21,424,122
Total	**19**	**63,423,888**	**63,445,582**

(in €'000)	No. of loans	Nominal amount	Clean carrying value: 31 December 2014
Loans to euro area Member States			
- to Spain	6	39,721,460	39,721,460
- to Cyprus	7	5,700,000	5,700,000
Total	**13**	**45,421,460**	**45,421,460**

The following table shows the movements of the loans to euro area Member States during 2014 and 2015:

(in €'000)	
1 January 2014 balance	**45,933,000**
New disbursements	1,100,000
- to Cyprus	1,100,000
Early repayments	(1,611,540)
- from Spain	(1,611,540)
31 December 2014 balance	**45,421,460**

(in €'000)	
1 January 2015 balance	**45,421,460**
New disbursements	22,025,036
- to Cyprus	600,000
- to Greece	21,425,036
Early repayments	(4,000,000)
- from Spain	(4,000,000)
Premium amortisation	(914)
31 December 2015 balance	**63,445,582**

8. Debt securities including fixed-income securities

The following table shows the details of the debt securities valuation and their classification on 31 December 2015:

(in €'000)	Clean amortised cost	Unrealised gains	Clean fair (carrying) value	Nominal amount
Paid-in capital portfolio	35,307,272	127,703	35,434,975	33,796,679
Fee investments	-	-	-	-
Total	**35,307,272**	**127,703**	**35,434,975**	**33,796,679**

The following table shows the details of the debt securities valuation and their classification on 31 December 2014:

(in €'000)	Clean amortised cost	Unrealised gains	Clean fair (carrying) value	Nominal amount
Paid-in capital portfolio	61,058,497	512,858	61,571,355	59,415,262
Fee investments	79,064	5	79,069	78,170
Total	**61,137,561**	**512,863**	**61,650,424**	**59,493,432**

On 31 December 2015, the clean amortised cost of the debt securities was €35.3 billion (31 December 2014: €61.1 billion), against a clean fair value of €35.4 billion (31 December 2014: €61.6 billion). The difference represents the unrealised result and is recognised directly in the equity within the fair value reserve.

In respect of the paid-in capital portfolio invested in debt securities, the ESM has an established investment policy setting strict eligibility criteria that restrict investment to issuers with the highest credit quality. Risk defines a limit structure to mitigate the maximum exposure per issuer. Regarding the fee investments, refer to Note 2.7.3.

On 31 December 2015, the debt securities including fixed income securities of the paid-in capital includes investments in securities that are not listed on regulated markets with a total clean fair value of €5.3 billion (31 December 2014: €11 billion). Their fair values are determined using valuation techniques, as disclosed in Note 2.7.4. All other securities are listed on regulated markets and the fair values of these assets are based on quoted market prices.

The ESM invests in debt securities issued by public bodies and debt securities issued by other issuers. Public bodies cover central banks, central governments, regional governments, local governments, supranational institutions and governmental agencies. On 31 December 2015, debt securities issued by public bodies amounted to €27.1 billion (31 December 2014: €55.5 billion), while debt securities issued by other borrowers amounted to €8.3 billion (31 December 2014: €6.1 billion).

In 2015, the ESM invested part of the paid-in capital portfolio in short-term assets denominated in a foreign currency (refer to Note 3.3.2).

9. Intangible assets

The following table shows the movements of intangible assets in 2015:

(in €'000)	Software	Total intangible assets
Historical cost		
1 January 2015 balance	207	**207**
Additions and disposals (net)	**4**	**4**
31 December 2015 balance	**211**	**211**
Accumulated amortisation		
1 January 2015 balance	(121)	**(121)**
Amortisation	(65)	**(65)**
31 December 2015 balance	**(186)**	**(186)**
Net book value		
31 December 2015 balance	**25**	**25**
31 December 2014 balance	**86**	**86**

10. Tangible assets

The following table shows the movements of tangible assets in 2015:

(in €'000)	Fixtures and fittings	Furniture and office equipment	UPS*	Total tangible assets
Historical cost				
1 January 2015 balance	3,164	1,470	-	**4,634**
Additions	36	104	188	**328**
Disposals	(70)	-	-	**(70)**
31 December 2015 balance	**3,130**	**1,574**	**188**	**4,892**
Accumulated depreciation				
1 January 2015 balance	(577)	(610)	-	**(1,187)**
Depreciation	(380)	(386)	(23)	**(789)**
Of the disposed assets	7	-	-	**7**
31 December 2015 balance	**(950)**	**(996)**	**(23)**	**(1,969)**
Net book value				
31 December 2015 balance	**2,180**	**578**	**165**	**2,923**
31 December 2014 balance	**2,587**	**860**	**-**	**3,447**

* Uninterrupted power supply

11. Prepayments and accrued income

The following table shows the breakdown of prepayments and accrued income. The receivables are due within one year:

(in €'000)	31.12.2015	31.12.2014
Interest receivable on:		
- Debt securities including fixed-income securities	217,518	456,526
- Loans and advances to euro area Member States	92,733	59,708
- Loans and advances to credit institutions	18	6,024
Amounts charged to the EFSF for administrative services (Note 19/25)	5,932	38,260
Commitment fee receivable (*)	-	34,252
Prepayments	624	291
Other (**)	1,180	-
Total prepayments and accrued income	**318,005**	**595,061**

(*) At the end of 2015, there was no commitment fee receivable as no negative cost of carry was incurred for the period (refer to Note 1.2 and 17).
(**) "Other" represents the spot revaluation and spread amortisation of ongoing derivative transactions (refer to Note 2.11).

12. Debts evidenced by certificates

The following table discloses the details of debt securities in issue outstanding on 31 December 2015, together with the coupon rates and due dates.

Financial assistance programme	ISIN code	Nominal amount (in €'000)	Issue date	Maturity date	Coupon
Greece	EU000A1U9852***	813,154	01/12/2015	27/02/2017	6M Euribor - 18 bps
Greece	EU000A1U9860***	811,860	01/12/2015	27/08/2017	6M Euribor - 20 bps
Greece	EU000A1U9878***	1,081,081	01/12/2015	27/02/2018	6M Euribor - 21 bps
Greece	EU000A1U9852***	809,755	08/12/2015	27/02/2017	6M Euribor - 18 bps
Greece	EU000A1U9860***	808,948	08/12/2015	27/08/2017	6M Euribor - 20 bps
Greece	EU000A1U9878***	1,077,630	08/12/2015	27/02/2018	6M Euribor - 21 bps
Long-term Funding	EU000A1U98Z1	7,000,000	15/10/2013	15/10/2018	1.250%
Long-term Funding	EU000A1U9803	3,000,000	20/11/2013	20/11/2023	2.125%
Long-term Funding	EU000A1U9811	6,000,000	04/03/2014	04/03/2021	1.375%
Long-term Funding	EU000A1U9829	3,000,000	14/05/2014	15/10/2019	0.875%
Long-term Funding	EU000A1U9803**	990,750	27/06/2014	20/11/2023	2.125%
Long-term Funding	EU000A1U9845	3,000,000	17/03/2015	17/10/2017	0.000%
Long-term Funding	EU000A1U9829**	2,000,000	28/07/2015	15/10/2019	0.875%
Long-term Funding	EU000A1U9886	6,000,000	15/09/2015	17/12/2018	0.050%
Long-term Funding	EU000A1U9894	3,000,000	23/09/2015	23/09/2025	1.000%
Long-term Funding	EU000A1U9902	3,000,000	20/10/2015	20/10/2045	1.750%
Long-term Funding	EU000A1U9910	4,000,000	03/11/2015	03/11/2020	0.100%
Long-term Funding	EU000A1U9928	1,500,000	17/11/2015	17/11/2036	1.625%
Long-term Funding	EU000A1U9936	1,000,000	01/12/2015	01/12/2055	1.850%
Short-term Funding	EU000A1U9837	4,000,000	28/10/2014	28/10/2016	N/A*
Short-term Funding	EU000A1U9837**	987,500	27/11/2014	28/10/2016	N/A*
Short-term Funding	EU000A1U99M7	1,925,300	23/07/2015	21/01/2016	N/A*
Short-term Funding	EU000A1U99P0	2,487,500	20/08/2015	18/02/2016	N/A*
Short-term Funding	EU000A1U99R6	2,478,500	24/09/2015	24/03/2016	N/A*
Short-term Funding	EU000A1U99S4	2,440,400	08/10/2015	07/01/2016	N/A*
Short-term Funding	EU000A1U99T2	2,438,250	22/10/2015	21/04/2016	N/A*
Short-term Funding	EU000A1U99U0	2,496,700	05/11/2015	04/02/2016	N/A*
Short-term Funding	EU000A1U99V8	2,487,750	19/11/2015	19/05/2016	N/A*
Short-term Funding	EU000A1U99W6	1,485,400	03/12/2015	10/03/2016	N/A*
Total		**72,120,478**			

* Zero-coupon bond
** Tap issue
*** Floating rate notes issued for disbursements in kind (cashless disbursements)

The following table discloses the details of debt securities in issue outstanding on 31 December 2014, together with the coupon rates and due dates.

Financial assistance programme	ISIN code	Nominal amount (in €'000)	Issue date	Maturity date	Coupon
Cyprus	EU000A1U98Y4***	1,500,000	27/09/2013	27/03/2015	6M Euribor - 21 bps
Spain	EU000A1U98W8***	12,000,000	11/12/2012	11/12/2015	6M Euribor - 6 bps
Spain	EU000A1U98X6***	1,865,000	05/02/2013	05/08/2015	6M Euribor - 15 bps
Long-term Funding	EU000A1U98Z1	7,000,000	15/10/2013	15/10/2018	1.250%
Long-term Funding	EU000A1U9803	3,000,000	20/11/2013	20/11/2023	2.125%
Long-term Funding	EU000A1U9811	6,000,000	04/03/2014	04/03/2021	1.375%
Long-term Funding	EU000A1U9829	3,000,000	14/05/2014	15/10/2019	0.875%
Long-term Funding	EU000A1U9803**	990,750	27/06/2014	20/11/2023	2.125%
Short-term Funding	EU000A1U98G1	1,490,000	24/07/2014	22/01/2015	N/A*
Short-term Funding	EU000A1U98J5	1,489,700	21/08/2014	19/02/2015	N/A*
Short-term Funding	EU000A1U98L1	983,750	18/09/2014	19/03/2015	N/A*
Short-term Funding	EU000A1U98M9	998,150	09/10/2014	08/01/2015	N/A*
Short-term Funding	EU000A1U98N7	972,000	23/10/2014	23/04/2015	N/A*
Short-term Funding	EU000A1U9837	4,000,000	28/10/2014	28/10/2016	N/A*
Short-term Funding	EU000A1U98P2	972,250	06/11/2014	05/02/2015	N/A*
Short-term Funding	EU000A1U98Q0	995,000	20/11/2014	21/05/2015	N/A*
Short-term Funding	EU000A1U9837**	987,500	27/11/2014	28/10/2016	N/A*
Short-term Funding	EU000A1U98R8	994,800	04/12/2014	05/03/2015	N/A*
Total		**49,238,900**			

* Zero-coupon bond
** Tap issue
*** Floating rate notes issued for disbursements in kind (cashless disbursements)

The following table shows the movements of the debt securities in issue in 2014 and 2015:

(in €'000)	
1 January 2014 balance	**60,026,441**
Issuance during the period	53,443,958
Maturities during the year	(64,334,450)
Premiums/discounts amortisation	27,659
31 December 2014 balance	**49,163,608**

(in €'000)	
1 January 2015 balance	**49,163,608**
Issuance during the period	70,697,915
Maturities during the year	(47,795,100)
Premiums/discounts amortisation	(11,578)
31 December 2015 balance	**72,054,845**

All debt securities in issue on 31 December 2014 and 31 December 2015 are issued under English law as the governing law.

13. Other liabilities

On 31 December 2015, the other liabilities were composed of suppliers' invoices and staff costs related payables which were not yet settled, amounting to €9.8 million (31 December 2014: €23.6 million), from which nil (31 December 2014: €14.8 million) is against the EFSF.

14. Accruals and deferred income

The following table shows the breakdown of the accruals and deferred income:

(in €'000)	31.12.2015	31.12.2014
Interest payable on debts evidenced by certificates	128,824	103,774
Deferred income on up-front service fee	242,204	169,593
Other (*)	75,107	-
Total accruals and deferred income	**446,135**	**273,367**

(*) "Other" represents the spot revaluation and spread amortisation of ongoing derivative transactions (refer to Note 2.15).

As explained in Note 2.3, the amortisation of the up-front service fee is recognised in the profit and loss account on a linear basis, under 'Interest receivable and similar income on loans to euro area Member States'.

15. Subscribed capital

(in €'000)	Subscribed capital	Subscribed, uncalled capital	Subscribed, called capital
1 January 2014	**700,000,000**	**(620,000,000)**	**80,000,000**
Subscription to the authorised capital	1,935,300	(1,935,300)	-
Authorised capital calls	-	221,200	221,200
31 December 2014	**701,935,300**	**(621,714,100)**	**80,221,200**

(in €'000)	Subscribed capital	Subscribed, uncalled capital	Subscribed, called capital
1 January 2015	**701,935,300**	**(621,714,100)**	**80,221,200**
Subscription to the authorised capital	2,863,400	(2,863,400)	-
Authorised capital calls	-	327,200	327,200
31 December 2015	**704,798,700**	**(624,250,300)**	**80,548,400**

On 31 December 2015, the ESM's shareholders were the 19 euro area Member States. The contribution key for subscribing to the ESM authorised capital is based on the key for subscription, by the national central banks of the ESM Members, of the ECB's capital.

Latvia joined the ESM on 13 March 2014 and subscribed to an authorised capital of 19,353 shares with a par value of €100,000 each, representing €1.9 billion of subscribed capital of which €221.2 million was called. On 31 December 2015 Latvia had already made the first two instalments for the payment of paid-in shares in the amount of €88.5 million. Lithuania joined the ESM on 3 February 2015 and subscribed to an authorised capital of 28,634 shares with a par value of €100,000 each, representing €2.9 billion of subscribed capital of which €327.2 million was called. On 31 December 2015 Lithuania had made the first instalment for the payment of paid-in shares in the amount of €65.4 million.

On 31 December 2015, the authorised capital was €704.8 billion (31 December 2014: €701.9 billion), divided into 7,047,987 shares (31 December 2014: 7,019,353 shares), with a par value of €100,000 each, and is split according to the contribution key. Out of the total authorised capital, €624.3 billion (31 December 2014: €621.7 billion) is callable. On 31 December 2015, the called subscribed capital amounted to €80.5 billion (31 December 2014: €80.2 billion), of which €80.2 billion (31 December 2014: €80.0 billion) is paid.

ESM Members 31 December 2015	ESM Key (%)	Number of shares	Subscribed capital (in €'000)	Subscribed capital called and paid (in €'000)
Kingdom of Belgium	3.4534	243,397	24,339,700	2,781,680
Federal Republic of Germany	26.9616	1,900,248	190,024,800	21,717,120
Republic of Estonia	0.1847	13,020	1,302,000	148,800
Ireland	1.5814	111,454	11,145,400	1,273,760
Hellenic Republic	2.7975	197,169	19,716,900	2,253,360
Kingdom of Spain	11.8227	833,259	83,325,900	9,522,960
French Republic	20.2471	1,427,013	142,701,300	16,308,720
Italian Republic	17.7917	1,253,959	125,395,900	14,330,960
Republic of Cyprus	0.1949	13,734	1,373,400	156,960
Republic of Latvia	0.2746	19,353	1,935,300	88,480
Republic of Lithuania	0.4063	28,634	2,863,400	65,440
Grand Duchy of Luxembourg	0.2487	17,528	1,752,800	200,320
Malta	0.0726	5,117	511,700	58,480
Kingdom of the Netherlands	5.6781	400,190	40,019,000	4,573,600
Republic of Austria	2.7644	194,838	19,483,800	2,226,720
Portuguese Republic	2.4921	175,644	17,564,400	2,007,360
Republic of Slovenia	0.4247	29,932	2,993,200	342,080
Slovak Republic	0.8184	57,680	5,768,000	659,200
Republic of Finland	1.7852	125,818	12,581,800	1,437,920
Total	**100.00**	**7,047,987**	**704,798,700**	**80,153,920**

On 31 December 2015, the subscribed capital called but not paid amounted to € 0.4 billion and was related to Latvia and Lithuania (31 December 2014: €0.2 billion related to Latvia). There are three different instances when a capital call can be made, in accordance with Article 9 of the ESM Treaty.

i. A general capital call under Article 9(1) of the ESM Treaty concerns payment of the initial capital and an increase of paid-in capital that could be necessary, for example, to raise the lending capacity. To initiate such a call, the Managing Director of the ESM would make a proposal to the Board of Governors outlining the objective of such a call, the amounts and contributions for each shareholder, and a proposed payment schedule. The Board of Governors, by mutual agreement, may call in authorised capital at any time.

ii. A capital call under Article 9(2) of the ESM Treaty to replenish paid-in capital could happen for two reasons:

- to cover a shortfall due to a non-payment by a beneficiary country and,
- if losses occurring due to other factors reduce the countervalue of the paid-in capital below the threshold of 15% of the maximum lending volume of the ESM.

The Managing Director would make a proposal to the Board of Directors, which would specify the losses incurred and the underlying reasons. A simple majority of the Board of Directors is required to agree to call in capital under these circumstances.

iii. An emergency capital call, under Article 9(3) of the ESM Treaty to avoid default of an ESM payment obligation to its creditors.

The Managing Director has responsibility for making such a capital call to ESM shareholders if there were a risk of default. As stated in the ESM Treaty, the ESM shareholders have irrevocably and unconditionally undertaken to pay on demand such a capital within seven days of receipt of the demand.

If an ESM Member fails to meet the required payment under a capital call made pursuant to Article 9(2) or (3), a revised increased capital call would be made to all ESM Members by increasing the contribution rate of the remaining ESM Members on a pro-rata basis, according to Article 25(2) of the ESM Treaty. When the ESM Member that failed to contribute settles its debt to the ESM, the excess capital is returned to the other ESM Members.

16. Reserve fund

As foreseen by Article 24 of the ESM Treaty, the Board of Governors shall establish a reserve fund and, where appropriate, other funds. Without prejudice to the distribution of dividends pursuant to Article 23 of the ESM Treaty, the net income generated by the ESM operations and the proceeds of possible financial sanctions received from the ESM Members under the multilateral surveillance procedure, the excessive deficit procedure and the macro-economic imbalances procedure established under the Treaty on the Functioning of the European Union (TFEU) are put aside in a reserve fund, in accordance with Chapter 5 of the ESM Treaty. The primary purpose of the reserve fund is the absorption of potential losses.

On 19 June 2014, the Board of Governors established the reserve fund and it decided on 18 June 2015 at their annual general meeting to appropriate the net result of 2014 amounting to €443.9 million to the reserve fund. As a result, the outstanding balance of the reserve fund on 31 December 2015 was €697.3 million.

17. Interest receivable and similar income on loans and advances to euro area Member States

Interest receivable and similar income on loans and advances to euro area Member States are detailed as follows:

(in €'000)	2015	2014
Interest on loans (*)	447,113	432,265
Amortisation loan premium	(914)	-
Amortisation up-front service fee	37,518	33,091
Commitment fee (**)	-	34,252
Total interest and similar income	**483,717**	**499,608**

(*) The interest on loans comprises base rate interest representing the cost of funding of the ESM, the margin and the annual service fee as the ESM Pricing Policy defines them.
(**) In 2015, no commitment fee receivable was recorded as no negative cost of carry was incurred due to the current negative yields on related short term funding instruments (refer to Note 1.2 and 11).

18. Interest receivable and similar income on debt securities including fixed-income securities

The geographical breakdown of the interest receivable and similar income on debt securities including fixed-income securities is detailed as follows:

(in €'000)	2015	2014
Euro area issuers	65,969	100,779
Other EU issuers	10,844	9,806
EU supranational organisations	39,308	62,879
Total European Union	**116,121**	**173,464**
Other non-EU issuers	11,240	5,106
Other supranational organisations	10,277	8,904
Total outside the European Union	**21,517**	**14,010**
Total interest and similar income	**137,638**	**187,474**

19. Other operating income

The EFSF has asked the ESM to provide administrative and other support services to assist it in performing its activities. To formalise this cooperation, the ESM and EFSF entered into a service level agreement from 1 January 2013.

Under the agreement's terms, the ESM is entitled to charge the EFSF service fees to achieve a fair cost-sharing arrangement. For the services during the financial year 2015, the ESM charged the EFSF €24.6 million (2014: €21.3 million), from which €5.9 million had yet to be paid on the balance sheet date (refer to Note 11).

20. Net profit on financial operations

Net profit on financial operations is detailed as follows:

(in €'000)	2015	2014
Net realised result of sales of debt securities	438,777	102,931
Net foreign exchange result	-	-
Total net result on financial operations	**438,777**	**102,931**

The net realised result of sales of debt securities reflects gains and losses realised at the date of derecognition of the respective financial assets. Up to that date, the debt securities are carried at fair value and unrealised gains and losses are recorded in the equity within the fair value reserve.

21. Staff costs

Staff costs are detailed as follows:

(in €'000)	2015	2014
Salaries and allowances	16,670	13,501
Social security costs	884	678
Pension costs	4,899	4,969
Total staff costs	**22,453**	**19,148**

The ESM employed 148 persons on 31 December 2015 including three trainees (31 December 2014: 122).

In addition to its own employees, the ESM has expenses for employees seconded from other International Financial Institutions, as well as interim and temporary staff hired from external agencies. The related costs amount to €1.1 million for the 2015 financial year (2014: €1.1 million) and are accounted for as 'Other administrative expenses' (refer to Note 22).

22. Other administrative expenses

Other administrative expenses consist of fees paid for professional services and miscellaneous operating expenses and are detailed as follows:

(in €'000)	2015	2014
Outsourced services (mainly IT, HR and accounting services)	6,583	4,307
Treasury related services	2,134	3,808
Advisory services	6,366	3,386
Rental and related services	2,937	2,831
IT Hardware	2,253	1,783
Interim and secondment fees (Note 21)	1,094	1,088
Legal services	1,217	851
Rating agencies fees	504	359
Other services	3,578	3,348
Total other administrative expenses	**26,666**	**21,761**

23. Off-balance commitments

The off-balance sheet commitments represent the undisbursed part of the financial assistance programmes and are detailed as follows:

(in €'000)	2015	2014
Financial assistance programme to Cyprus	2,668,000	3,268,000
Financial assistance programme to Greece	64,597,572	-
Total undisbursed amounts	**67,265,572**	**3,268,000**

Any further disbursement is subject to conditionality in line with the Memorandum of Understanding attached to the Financial Assistance Facility Agreement.

24. Derivatives

The ESM uses derivatives for risk management purposes only. In 2015, the ESM entered into foreign exchange derivative transactions such as currency swaps and currency forward contracts to hedge the currency risk related to non-euro denominated investments.

All derivatives transactions are booked at nominal value as off-balance sheet items at the date of the transaction and are detailed as follows:

(in €'000)	Notional Amounts (receivable)	Notional Amounts (payable)	Fair Value
Currency swaps	2,374,954	(2,448,428)	(73,408)
Currency forwards	43	(46)	(2)
Total	**2,374,997**	**(2,448,474)**	**(73,410)**

On 31 December 2015, all derivative financial instruments had a final maturity of less than one year and all of them were concluded with a euro area central bank or with the Bank of International Settlements.

24.1. Interest receivable and interest payable on derivatives

The positive or negative spread between the spot amount and forward settlement amount of currency swaps and currency forwards were linearly amortised in 'Interest receivable and similar income' (€1.3 million) or 'Interest payable and similar charges' (€0.6 million).

25. Related-party transactions

Key management

The ESM has identified members of the Board of Governors, Board of Directors, and the Management Board as key management personnel.

The members of the Board of Governors and the Board of Directors were not entitled to remuneration during the period.

Transactions with shareholders

The ESM granted loans to Spain, Cyprus, and Greece, which are also ESM shareholders, as disclosed in more detail in Note 7. In the course of its investment activity, the ESM purchases debt securities issued by its shareholders. Such securities are reported as 'Debt securities including fixed-income securities' on the balance sheet.

Transactions with the European Financial Stability Facility (EFSF)

The EFSF is a public limited liability company (Société Anonyme) incorporated under Luxembourg law on 7 June 2010 following decisions taken by the euro area Member States on 9 May 2010 within the framework of the Ecofin Council. The EFSF's mandate is to safeguard financial stability in Europe by providing financial assistance to euro area Member States within the framework of a macro-economic adjustment programme.

The EFSF was created as a temporary rescue mechanism. In accordance with its Articles of Association, the EFSF will be dissolved and liquidated when all financial assistance provided to euro area Member States and all funding instruments issued by the EFSF have been repaid in full. As of 1 July 2013, the EFSF may no longer engage in new financing programmes or enter into new loan facility agreements.

External expenses incurred by the EFSF in relation to establishing and running the ESM were recharged by the EFSF to the ESM, together with other non-expense related items. The total €14.8 million of such recharged items, recognised as expenses in 2012, were paid in 2015 (refer to Note 13).

The EFSF has asked the ESM to provide certain administrative services and other support services to facilitate the performance of its activities. To formalise this cooperation, the two organisations entered into a service level agreement. The ESM charged the EFSF €24.6 million for the financial year 2015 (2014: €21.3 million), from which €5.9 million had not yet been paid at balance sheet date (refer to Note 11) under the terms of the Agreement. The ESM recognised these amounts as other operating income in the profit and loss account.

On a temporary basis, the ESM invested in short-term EFSF-issued notes. The transitional investment portfolio was of a temporary nature and expired in November 2014. The ESM did not invest in notes issued by the EFSF in 2015.

26. Audit fee

The total fees accrued are presented as follows:

(in €'000)	2015	2014
Audit fees	243	240
Total Audit fees	**243**	**240**

The external auditor did not provide the ESM with non-audit services.

27. Events after the reporting period

Except for those included in the notes to the financial statements, there have been no material post-balance-sheet events which could require disclosure or adjustment to the 31 December 2015 financial statements.

05

EXTERNAL AUDITOR'S REPORT ON THE 2015 FINANCIAL STATEMENTS

TO THE BOARD OF GOVERNORS OF THE EUROPEAN STABILITY MECHANISM

Luxembourg, 18 March 2016

We have audited the accompanying financial statements of European Stability Mechanism, which comprise the balance sheet as at 31 December 2015, the profit and loss account, the statement of changes in equity and the statement of cash flows for the year then ended and a summary of significant accounting policies and other explanatory information.

Board of Directors' responsibility for the financial statements

The Board of Directors is responsible for the preparation and fair presentation of these financial statements in accordance with the general principles of the Directive 86/635/EEC of the Council of the European Communities of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions, as amended by Directive 2001/65/EC of 27 September 2001, by Directive 2003/51/EC of 18 June 2003 and by Directive 2006/46/EC of 14 June 2006 (the Directives), and for such internal control as the Board of Directors determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Responsibility of the *"Réviseur d'entreprises agréé"*

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing as adopted for Luxembourg by the "Commission de Surveillance du Secteur Financier". Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the annual accounts are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the judgment of the "Réviseur d'entreprises agréé", including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the "Réviseur d'entreprises agréé" considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the Board of Directors, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements give a true and fair view of the financial position of European Stability Mechanism as of 31 December 2015, and of the results of its operations and its cash flows for the year then ended in accordance with the general principles of the Directives.

PricewaterhouseCoopers,
Société coopérative

Represented by
Philippe Sergiel

06

REPORT OF THE BOARD OF AUDITORS ON THE 2015 FINANCIAL STATEMENTS

Luxembourg, 21 March 2016

The Board of Auditors of the European Stability Mechanism (ESM) was set up pursuant to Article 30 of the Treaty establishing the ESM and Article 24 of the ESM By-Laws. The Board of Auditors is independent from the Board of Directors and its members are appointed directly by the Board of Governors.

The Board of Auditors carries out independent audits of regularity, compliance, performance and risk management of the ESM, inspects the ESM accounts, and monitors and reviews the ESM's internal and external audit processes and results. Information on the audit work of the Board of Auditors, its audit findings, conclusions and recommendations for the year ended 31 December 2015 are included in the annual report, which has been prepared in accordance with Article 24(6) of the ESM By-Laws and submitted to the Board of Governors.

This Board of Auditors report on the financial statements is addressed to the Board of Governors in accordance with Article 23(2)(d) of the ESM By-Laws. It is delivered in respect of the financial statements of the ESM for the year ended 31 December 2015.

In 2015 the ESM has completed the development of the integrated control framework (ICF). This allowed the ESM Management to assert that, at 31 December 2015, the ESM maintained effective internal controls. It will require a period of time to fully embed all elements of the ICF within the institution. The Board of Auditors notes that, to the best of its judgment, no other material matters have come to its attention that would prevent it from recommending that the Board of Governors approve the ESM financial statements for the year ended 31 December 2015.

On behalf of the Board of Auditors

Igors Ludboržs
Chairperson

ACRONYMS AND ABBREVIATIONS

ALM	Asset and Liability Management
Bps	Basis points
BRRD	Bank Recovery and Resolution Directive
CDS	Credit Default Swap
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
DMO	Debt Management Office
DRI	Direct Recapitalisation Instrument
EA	Euro area
EBA	European Banking Authority
ECB	European Central Bank
EFSF	European Financial Stability Facility
EMU	Economic and Monetary Union
ESM	European Stability Mechanism
ESRB	European Systemic Risk Board
EU	European Union
EWS	Early Warning System
GDP	Gross domestic product
GLF	Greek Loan Facility
HICP	Harmonised index of consumer prices
IMF	International Monetary Fund
MoU	Memorandum of Understanding
NPL	Non-performing loan
NPV	Net present value
RHS	Right hand scale
SMEs	Small- and medium-sized enterprises
SMP	Securities markets programme
SSA	Sovereign, Supranational and Agency (bond issuers)
SSM	Single Supervisory Mechanism
SRB	Single Resolution Board
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
VaR	Value at Risk
WAM	Weighted average maturity

COUNTRY CODE	COUNTRY NAME
BE	Belgium
DE	Germany
EE	Estonia
IE	Ireland
EL	Greece
ES	Spain
FR	France
IT	Italy
CY	Cyprus
LV	Latvia

COUNTRY CODE	COUNTRY NAME
LT	Lithuania
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