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European Stability Mechanism

2016
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 Members with 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 Members' national bonds.

The ESM provides financial assistance to beneficiary Members addressing weaknesses in their economies through reforms which are jointly agreed by that Member, the European Commission, in liaison with the European Central Bank (ECB) and, where applicable, the International Monetary Fund (IMF). The reforms are required to be consistent with the measures of economic policy coordination provided for in the Treaty on the Functioning of the European Union.

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

Note: The ESM 2016 Annual Report contains the audited financial statements as at 31 December 2016, together with the report of the external auditor in respect of its 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 2016 financial year, except when stated otherwise. The information related to the composition of the Board of Governors and Board of Directors reflects their composition as of 1 April 2017. The economic report (Chapter I) includes certain information available up to and including 11 May 2017, but all historic financial data there set out is limited to the period to 31 December 2016.

“Europe’s most urgent challenges – fighting terrorism, protecting our borders, making the euro area more robust, and climate change – can only be tackled if countries join forces.

The ESM’s approach of providing financial solidarity … in return for strict economic reforms works … All former programme countries are among the growth champions of Europe.”

KLAUS REGLING
Managing Director
European Stability Mechanism

MESSAGE FROM THE MANAGING DIRECTOR

Europe's leaders commemorated the founding of the European Union in Rome, the city where six countries tied their fate together 60 years ago, in March of this year. It is all the more welcome, then, that recent national elections point towards a continuation of pro-European policies, rather than the abrupt change in the opposite direction many were predicting a few months ago. The French election was the latest affirmation of the spirit of cross-border cooperation that underlies the 1957 Treaty of Rome.

This clear result shows that Europe's citizens have understood it would be a profound mistake to undo the work that has brought six decades of peace and prosperity to our continent. Europe's most urgent challenges – fighting terrorism, protecting our borders, making the euro area more robust, and climate change – can only be tackled if countries join forces. That does not mean we have to give up national identities. Nor does it mean a gradual move towards a federal Europe. But even when countries act purely out of self-interest, it means they often need to work with their neighbours.

At the same time, Europe should take the wave of criticism from so many voters seriously. Policymakers should ask themselves why people are dissatisfied, and act when there is the need to. It is equally important to point out the tangible benefits of cross-border cooperation and the euro. As the head of the ESM – an institution that defends the integrity of the euro – I see this as a crucial task.

In my frequent meetings with investors around the world, I am almost always asked about the European economy and the future of the euro. And while I admit that there are still problems and challenges, I also emphasise the many positive aspects of European integration. In this report, the 19 euro area finance ministers talk about the benefits of the euro, each from the perspective of their own country. It would be ill-advised to underestimate such an endorsement from the democratically elected representatives of the 340 million citizens of the euro area.

The euro eliminates the cost of converting currencies, it enhances price transparency across borders and boosts competition and thus productivity and growth. In plain terms, this means better and cheaper products and higher standards of living.

Damaging intra-European currency turmoil, which was common in the period from the end of the Bretton Woods system until the beginning of EMU, is no longer possible. And the euro area – the second-largest economy in the world – has much more influence around the world than its individual members, as new economic heavyweights such as China and India are gaining clout.

This report highlights such benefits. The euro area is fortunate enough in that its citizens agree. More than two-thirds of the people support the euro, and the trend is rising. A majority of the people in each individual euro area country also support it. This is helped by an economic recovery that is now well under way, and that is supported by Europe's reaction to the crisis.

It is often not sufficiently recognised that adjustments in the fiscal and competitiveness areas had a positive impact on growth and employment after some time, even if they were initially painful.

Greater economic policy coordination and the establishment of new institutions such as the ESM and banking union were other material improvements. The euro area has staged a sustained recovery as a result, with growth between 1.5% and 2%, well above trend growth. This means that the output gap is being closed and that unemployment is coming down. From a per capita perspective, Europe's growth is moving in line again with the United States. This had been the case for decades but the relation was interrupted during the crisis. Per-capita growth is an important indicator, as it shows how much wealth is created per individual, abstracting from demographic differences.

Additional strengths of the European economy are the fact that the employment rate is now higher than in 2000, whereas it dropped in the same period in the US Fiscal deficits across the euro area have been converging and, at the aggregate level, are now about one third of those in the US or Japan. Large current account deficits, one of the major contributing factors to the crisis, have largely disappeared. Banks are also slowly catching up with their peers in the US, although non-performing loans remain too high. This issue needs to be addressed, because it weighs down profitability and stands in the way of credit growth – and therefore economic growth – particularly in certain countries.

It is particularly gratifying to see that all former programme countries – Spain, Ireland, Portugal, and Cyprus – are among the growth champions of Europe. It shows that the ESM's approach of providing financial solidarity to euro area countries in return for strict economic reforms works. Greece remains the ESM's only active programme country, a sign of how far Europe has come since the peak of the crisis. The country had to tackle bigger problems than others to modernise its economy, and the interruption of this process in early 2015 was extremely costly. But Greece too can stand on its own as long as it implements the reforms agreed with creditors.

The ESM, a lender of last resort for sovereigns, fulfils an institutional role that did not exist in Europe before the crisis. From its humble beginnings, when a staff of eight people issued the first bond, I have seen the organisation grow to a headcount of 170 this year – still a low number in relation to the large sums of money that we deal with. And as the organisation grows, so does the number of tasks it is entrusted with. This year, the ESM completed an evaluation of its past programmes under the leadership of the high-level independent evaluator, Gertrude Tumpel-Gugerell. Dozens of stakeholders in Europe and the US provided input for the report, which contains important lessons for the future. With this first evaluation, the ESM has followed the normal practice at other international organisations.

The ESM also contributed to the debt sustainability analysis for Greece that the Eurogroup used for its decision on further debt relief. The Eurogroup mandated the ESM to design the short-term debt measures for Greece, which was envisaged to reduce the debt stock by 20 percentage points by the year 2060. This complex exercise required hard work from our funding and lending teams, who are implementing the measures.

In October 2016, the ESM was one of the organisers of the inaugural high-level dialogue of Regional Financing Arrangements, which exist on all continents, in Washington, DC. The ESM is by far the largest of these institutions, which play an increasingly important role in the Global Financial Safety Net.

Last but not least, I was honoured to be appointed for a second five-year term at the helm of the ESM. I will continue to manage the institution in an efficient way. Europe has clearly left the crisis behind it, but enough work remains to be done. I see it as the duty of the ESM to continue to make monetary union more robust, and the economy more resilient. This is what is needed for Europe to stay relevant, and for its citizens to receive the full benefits of the euro.

LETTER OF TRANSMITTAL TO THE BOARD OF GOVERNORS

15 June 2017

Dear Chairperson,

I have the honour of presenting to the Board of Governors the annual report in respect of the financial year 2016, 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 2016. It also contains the audited financial statements as at 31 December 2016, as drawn up by the Board of Directors on 30 March 2017 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

2016: THE YEAR IN REVIEW

2016

JANUARY
EFSF/ESM funding team launches German private placements under its new N-bond (Namensschuldverschreibungen) programme

15 FEBRUARY
Former ECB President Jean-Claude Trichet speaks at ESM conference

31 MARCH
Cyprus successfully exits ESM programme

12 MAY
ESM Board of Directors (BoD) approves updated Code of Conduct

16 JUNE
ESM Board of Governors (BoG) agrees with Greece on further policy reforms, unlocking the second, €10.3 billion tranche of assistance

16 JUNE
BoG approves ESM transparency initiative to increase understanding of the institution's decision-making process on programmes

17 JUNE
BoD authorises the first of three disbursements under the second tranche to Greece, for €7.5 billion, following up on 25 October with agreement to disburse the rest

29 AUGUST
Gertrude Tumpel-Gugerell is appointed high-level independent evaluator, after the BoG endorsed on 16 June the ESM plan to evaluate former EFSF/ESM country programmes to learn how to improve its future work

22 SEPTEMBER
BoD approves revised investment guidelines, with changes designed to enhance the ESM's investment flexibility so that it can continue expanding its operations and better manage its assets

6 OCTOBER
Regional Financing Arrangements hold first annual high-level dialogue

24 OCTOBER
BoD approves revised ESM guidelines on borrowing operations, enabling the ESM to better manage interest rate risk through derivatives and to issue in currencies other than the euro, especially the US dollar

7 NOVEMBER
BoD approves Spain's fourth early repayment

1 DECEMBER
ESM revamps its website, including more analytical working and research papers

5 DECEMBER
Euro area finance ministers endorse ESM and EFSF short-term debt relief measures for Greece, followed by ESM BoG approval on 20 January 2017 and EFSF BoD approval on 23 January 2017

31 DECEMBER
ESM reaches its total final headcount of 169 staff, in line with the total headcount approved by the BoD in December 2015, as part of the ESM 2016 budget

Notes: The Board of Governors meets at least once a year and whenever the affairs of the ESM so require.
The Board of Directors met 12 times in 2016, while the Board Risk Committee and the Board Compensation Committee each held four physical meetings and several conference calls.

01 ECONOMIC DEVELOPMENTS

THE EURO: PLATFORM FOR STABILITY, SPRINGBOARD TO SUCCESS

In this year's ESM Annual Report, the Governors of the ESM Board, the euro area Finance Ministers, reflect on the benefits of the euro, a cornerstone of European integration. The creation of a single currency in January 1999 meant both an extraordinary challenge and an exceptional opportunity and, despite the crisis, it remains a simple truth: the euro is good for Europe and its citizens.

Throughout the pages of this annual report, the ESM Governors express their views on the euro's benefits. Their words underline a series of advantages the euro has brought to the area's citizens, societies, businesses, and countries. They point out that the euro means people no longer need to exchange currencies when travelling across Europe. The euro also eliminates exchange rate risk for trade and investment within the euro area. Citizens and firms no longer need to pay transaction fees for exchanging money, nor do they face exchange rate uncertainty within the area. They have more price and cost transparency across borders, promoting a greater choice of products and facilitating trade and investment. That transparency also fosters competition and, in turn, growth. By creating conditions for deeper economic integration, the euro ultimately adds to sustainable growth and the wellbeing of euro area citizens. The easier flow of goods, capital, and services, backed by a common currency, also creates a safer economic environment, in particular for small states, and contributes to economic and financial stability. The common currency allows companies to compete on a level playing field. The euro's introduction put an end to intra-European currency turmoil. On a broader scale, the common currency therefore supports peace and unity.

All these features that the ESM governors mention have helped to consolidate the euro as the second most important currency in the global monetary system, accounting for some 30% of transactions. In an increasingly challenging global geopolitical environment, visibility and bargaining power are strongly linked to size. Hence, the euro area is more powerful in a global environment than any individual country could be.

The recent financial crisis revealed shortcomings both in the euro's underlying architecture and in national growth models. But Europe drew the lessons from this crisis and tackled these problems. National governments undertook tough, far-reaching reforms to correct economic imbalances. Banking union was launched, economic governance at the EU level was reinforced, and the EFSF/ESM stability fund was established to provide a credible backstop for the euro area. The euro, whose very existence the crisis had called into question, emerged stronger and fitter from the crisis.

Citizens' continued support for the single currency is allowing member countries to take further steps to strengthen and complete the economic and financial architecture of the Economic and Monetary Union. Most Europeans have now put the crisis behind them. In the Eurobarometer poll, the popularity of the European Union and of the euro is consistently high. When asked whether the EU is a place of stability, 66% agree. A full 80% support the four freedoms – the free movement of goods, services, capital, and labour. And 70% support the euro. This is a ringing endorsement of the EU's work over the past decade and of European integration in general.

The ESM Governors acknowledge that, despite all these achievements, the euro area architecture needs to be developed further. Their remarks underscore that euro area countries remain committed to a challenging but promising reform agenda, which will contribute to a smoother functioning of the area both for the benefit of member countries and of those seeking to join. Completing this process will further demonstrate the long-run benefits of belonging to a large and stable economic area with robust governance.

JEROEN DIJSSELBLOEM

Minister of Finance of the Kingdom of the Netherlands, Chairperson of the Board of Governors

“The euro is key for our prosperity, opportunity, and stability in Europe. Easier trade and travel, eliminating exchange rate uncertainty and reducing transaction costs provide just that. In the long run people benefit from sustainable economic growth based on innovation and productivity growth.”

MACROECONOMIC AND FINANCIAL ENVIRONMENT

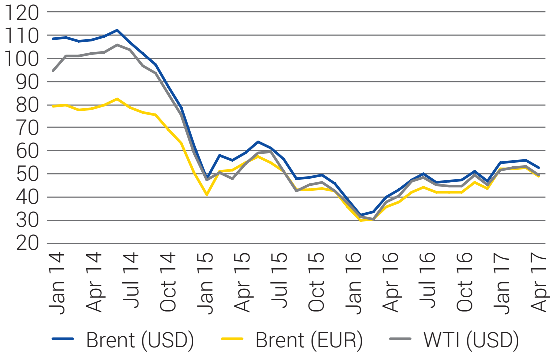
The euro area maintained solid economic growth in 2016. It remained robust despite a slowdown in international trade, and global and domestic political uncertainties. Tailwinds are also weakening, as once-depressed oil prices rise and a low euro appreciates. Headline inflation, while modest on average, accelerated sharply at the end of 2016 and in the beginning of 2017, driven mainly by an increase in energy prices from early-2016 lows. The economic outlook is positive overall and the broad-based recovery is expected to continue at a similar pace in 2017 although it is subject to risks.

Global financial market dynamics and monetary policy changed dramatically over the year. In early 2016, heightened fears of deflation and a potential hard landing in China led market players to shed risk and triggered further monetary policy easing by major central banks. By the end of the year, however, optimism about the likelihood of a fresh higher-growth higher-inflation global scenario replaced earlier concerns and investors started to price in a faster-than-previously expected tightening of central banks' expansionary policies.

Economic recovery shows resilience

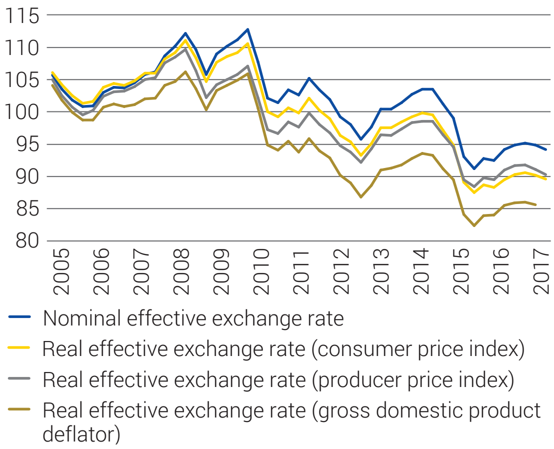
In 2016, the euro area economy showed considerable resilience and broadly maintained its momentum from 2015.[1] Real gross domestic product (GDP) growth reached 1.8%, despite slowing global GDP and trade, as well as economic uncertainty related to persisting geopolitical tensions and euro area uncertainties about the UK's exit from the European Union. Economic activity was supported, as before, by accommodative monetary policy, a mildly expansionary fiscal stance and still low, albeit climbing, oil prices and euro exchange rate (Figures 1 and 2). Growth for the euro area as a whole remained well above estimated potential growth.

Figure 1
Oil prices per barrel



Sources: Financial Times, Haver Analytics

Figure 2
Euro effective exchange rate
(Group of 19 countries, Q1/1999=100)



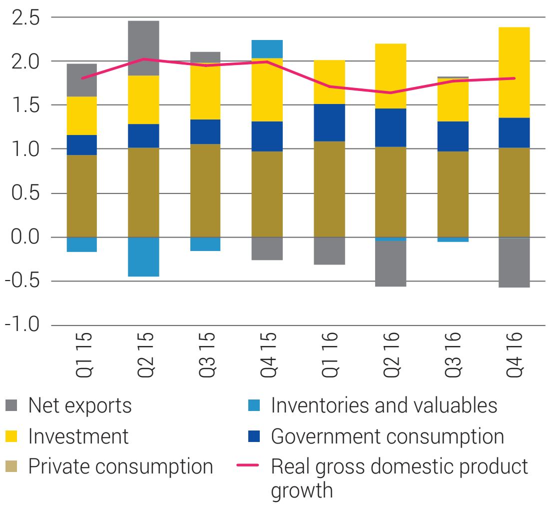
Source: European Central Bank

Domestic demand continues to drive the economic recovery (Figure 3). Private consumption benefited from high real household purchasing power thanks to low inflation, moderate wage growth, and rising employment. Government consumption regained momentum from a more relaxed fiscal policy. Investment also accelerated but remains significantly below pre-crisis levels. The contribution from external trade was mildly negative, which is not surprising given weak external demand.

All euro area countries were out of recession for the first time since 2007 (Figure 4). Looking at the

[1] Real GDP growth in Ireland reached 26.3% in 2015, heavily affected by the statistical treatment of the activities of multinational companies. The impact of these activities on aggregate euro area growth was roughly 0.5 percentage points. The distortions to the Irish national accounts prompted the construction of a new measure of underlying economic activity, which is first due for release in the summer of 2017.

Figure 3
Contributions to real gross domestic product growth
(in percentage points)

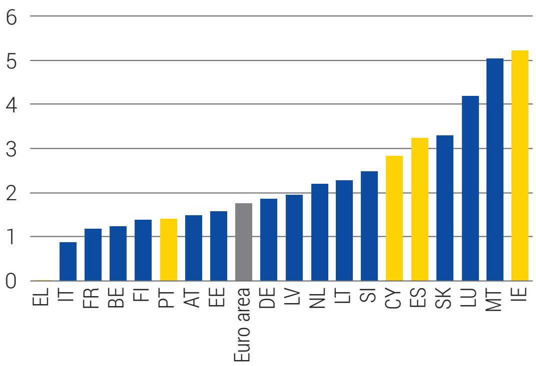


Source: Eurostat

EFSF/ESM programme countries, Ireland, Spain, and Cyprus figure among the best performers. Portugal remained somewhat below the euro area average, while Greece broadly stagnated following the recession that resulted from the political turmoil of 2015. Among other larger euro area countries, Germany and the Netherlands maintained solid growth, while France and Italy continued to stay below the euro area average.

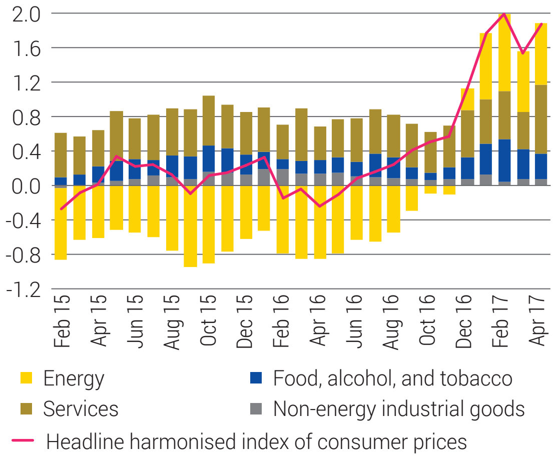
Headline inflation remained very low and uneven, on average at 0.2% in 2016, affected by the deep decline in oil prices at the beginning of the year. It sharply accelerated, however, towards the year-end due to an increase in the prices of energy from early-2016 lows and of unprocessed food (Figures 5 and 6). Core inflation, which strips out the more volatile food and energy components, remained relatively stable throughout the year at below 1%.

Figure 4
Real gross domestic product growth in 2016
(in %)



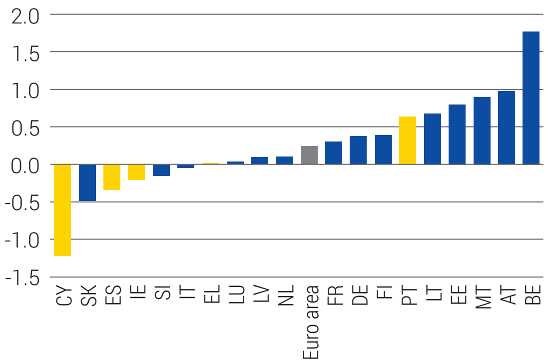
Note: EFSF/ESM programme countries in yellow.
Source: Eurostat

Figure 5
Contributions to harmonised index of consumer price inflation rate
(in percentage points)



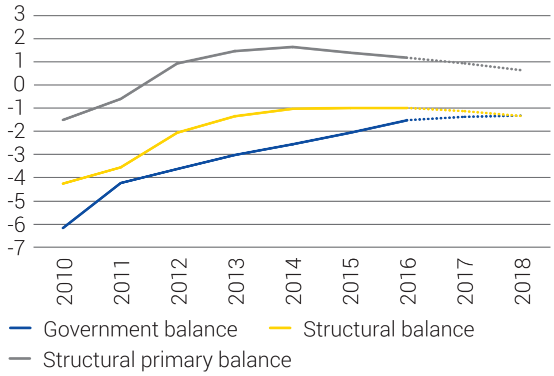
Source: Eurostat

Figure 6
Headline harmonised index of consumer price inflation in 2016
(in %)



Note: EFSF/ESM programme countries in yellow.
Source: Eurostat

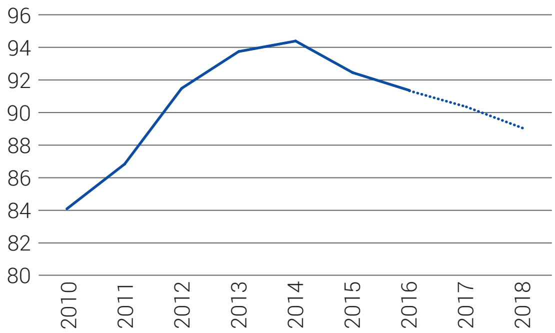
Figure 7
Euro area budget balances
(% of GDP)



Source: European Commission Economic Forecast Spring 2017

The government balance as a percentage of GDP improved further in 2016, due to a cyclical upswing and declining interest payments. The structural primary balance deteriorated slightly, signalling a mildly expansionary fiscal stance (Figure 7). The euro area government debt ratio declined for a second consecutive year in 2016 and is expected to continue trending lower (Figure 8).

Figure 8
Euro area government debt
(% of GDP)

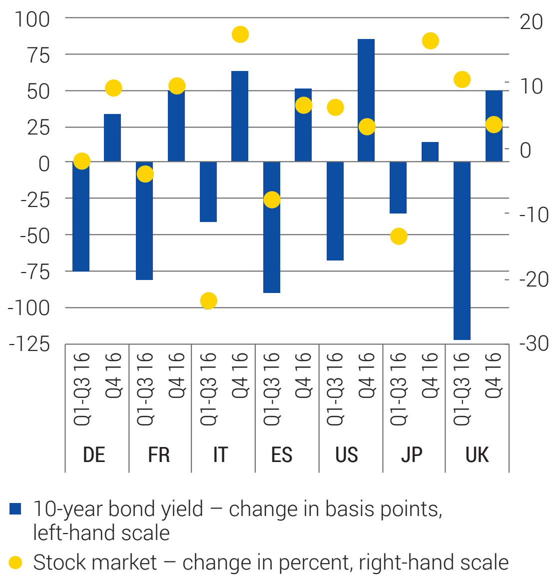


Source: European Commission Economic Forecast Spring 2017

Financial markets experienced large swings

In 2016, financial markets shifted from initial outright panic to a renewed appetite for risk later in the year. Early concerns about the global economic outlook and the risk of a hard landing in China hit markets hard. In just the first six weeks of the year, all major equity indices dropped between 6% and 20%, oil prices plummeted to 2003 lows, and the price of safe-haven assets shot higher. Towards year-end, investors turned more optimistic as global growth started to gain momentum and headline inflation figures accelerated. The outcome of the US presidential election, which resulted in a strong focus on fiscal policy to stimulate the US economy, and the OPEC agreement to cut oil production, also fuelled more positive market sentiment, triggering a rally in global stock markets and a sharp increase in sovereign bond yields, slopes, and spreads (Figure 9).

Figure 9
Change in sovereign bond yields and equity indices in selected countries



Source: Bloomberg

Naturally, monetary policy was also transformed during the year. In early 2016, amid financial volatility, subdued growth, and deflationary concerns, major central banks moved towards a more accommodative stance. In particular, while the US Federal Reserve paused in its tightening cycle, both the Bank of Japan in January and the ECB in March lowered their policy rates and expanded their asset purchase programmes. By late 2016, however, markets had become ever more aware that monetary policy could

JOHAN VAN OVERTVELDT

Minister of Finance of the Kingdom of Belgium,
ESM Governor

"The euro, as a common currency for 19 countries, has facilitated economic life and consolidated European integration. However, the work is not finished. We need to finalise the euro construction as soon as possible."

tighten faster than previously expected. In December, the Federal Reserve raised rates and pointed to three additional hikes in 2017, well above market expectations. Also in December, the ECB decided to extend its asset purchase programmes until at least the end of 2017, but reduced its monthly purchase pace to €60 billion from €80 billion as of April 2017.

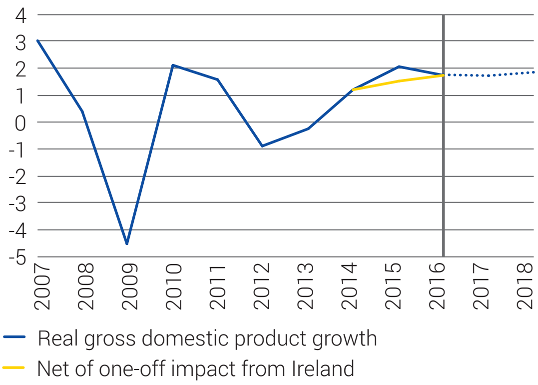
Amid these evolving dynamics, several market features remained constant throughout 2016. First, markets continued to weather apparently large shocks in good form, such as the unexpected results of the Brexit referendum and the US presidential election. Second, complaints about poor and fragile market liquidity remained pervasive, amid indications of impaired repo markets. How markets' resilience and liquidity will evolve in the near term as global central banks continue normalising their monetary policies is one of the biggest unknowns ahead.

Outlook remains positive, but risks are high

Euro area economic growth is expected to maintain its tempo in the coming years. The global economic upturn, still expansionary monetary policy, and positive effects from ongoing structural reforms will support growth, although the positive supply shocks from oil prices and euro depreciation will dissipate (Figure 10). Inflation is set to accelerate in 2017 amid the recovery in oil prices, but then slow and converge to core inflation after the effects from oil-price swings fade (Figure 11). Closing the output gap and tightening labour markets associated with higher wage growth should prompt a gradual pick-up in core inflation going forward. The economic outlook is subject to risks, such as geopolitical tensions, protectionism, and uncertainties related to the UK's exit from the European Union.

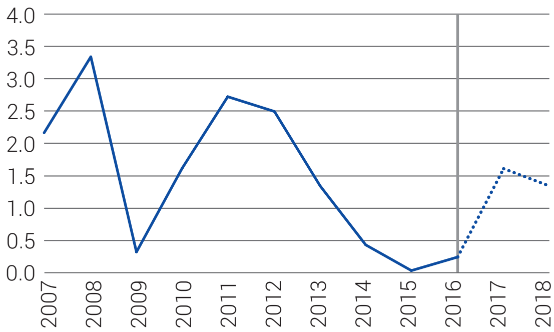
Financial markets' optimism in late 2016 of greater global economic growth and higher inflation ahead continued in early 2017. Indeed, following some promising macroeconomic and inflation figures, the perceived likelihood of three interest rate hikes in the US during 2017 has significantly increased, and in the euro area the ECB has acknowledged an improvement in the balance of risks. Central banks' forward guidance will continue to be critical to ensuring a smooth market reaction to these developments in the near- and medium-term.

Figure 10
Euro area real gross domestic product growth forecast
(in %)



Note: The estimated impact from Ireland on the euro area aggregate is a rough approximation for 2015 only.
Sources: European Commission Economic Forecast Spring 2017, ESM calculations

Figure 11
Euro area inflation forecast
(in %)



Source: European Commission Economic Forecast Spring 2017

ESM strengthens mandate-related economic research

The ESM continues to build and strengthen its economic research capabilities to support the organisation's mandate: to safeguard the financial stability of the euro area as a whole and of its Member States. To foster this research, the ESM is developing a series of activities, including the organising and hosting of professional events, the publication of a regular working paper series, and the 2016 launch of a discussion paper series. These activities contribute either to the development of a consistent institutional view on relevant economic developments or to the debate on evolving areas of interest to the ESM and its role. The ability to explain the ESM and its activities to academics with analytical rigour adds to the institution's overall credibility.

- Through the regular seminar series, ESM staff have the opportunity to learn from and discuss economic research on issues related to our mandate. These expert seminars are most often given by well-established academics, although more junior researchers are sometimes afforded the opportunity of discussing their work when it is related to areas of ESM expertise.

- Through our working papers series, and the videos that summarise them, the ESM disseminates the research efforts of its staff. The working paper series, which, after a thorough internal review, publishes both in-house research work and papers presented at our conferences and workshops, provides our staff the opportunity to discuss their research at other international financial institutions (IFIs), universities, central banks, and research centres. As of June 2017, the ESM working paper series had reached 24 issues, covering such core ESM topics as banking crises, sovereign ratings, and debt sustainability. In 2016, our staff delivered more than 20 lectures, including at the IMF, the Irish Economic Association Annual Conference, the Spring Meeting of Young Economists, the International Association for Applied Econometrics, European University Institute, Georgetown University, and Cambridge University, and published six papers in refereed academic journals.

- In 2016, the ESM launched a discussion paper series, which is intended to inform and stimulate public policy discussion. Like the working paper series, the discussion papers reflect the opinions of the authors, not the ESM, and can include expert contributions from outside the ESM.

- Through our conferences and co-organised workshops, we foster and contribute to debates on policies affecting our mandate. Last year the ESM held a lecture and co-organised two academic events. Former ECB president Jean-Claude Trichet held the lecture, providing an account of his crisis experience and the future of the euro area (February 2016). The first academic event, a workshop focusing on issues related to risk-sharing, was co-organised with the European University Institute (ADEMU) and the IMF (May 2016). The other workshop, dealing with policies aimed at resolving debt crises, was co-organised with Cambridge University, ADEMU, and the Center for Economic and Policy Research (September 2016).

Former ECB president Jean-Claude Trichet speaks at the ESM conference on 15 February 2016

Through this work, the ESM successfully reached out to the academic community, making its views known and encouraging fruitful research. In turn, these activities enabled a critical reflection on the ESM's work and approach.

PROGRAMME EVALUATION

EFSF/ESM conduct first evaluation of former programme countries

The EFSF/ESM launched the first evaluation of its financial assistance programmes in 2016. The exercise aims to draw lessons which will inform future ESM programme policies and practices. The results and recommendations are to be presented to and discussed by the Board of Governors at the ESM Annual Meeting on 15 June 2017, together with this Annual Report.

The evaluation of financial assistance programmes is an established practice among other international institutions, but it is a new task for the ESM. In early 2016, Jeroen Dijsselbloem, chairperson of the ESM Board of Governors, requested an in-depth evaluation of EFSF and ESM programmes. Half a year later, the Board of Governors approved its mandate, setting the precise scope and terms of reference in October 2016.

The evaluation addresses five programmes for five euro area Member States, as well as the post-programme period up to the end of June 2016. This includes EFSF programmes for Ireland, Portugal, and Greece (second programme), and also the ESM programmes for Spain and Cyprus. Since it is still ongoing, the ESM programme for Greece (third programme) was excluded from the exercise.

In determining the mandate of the evaluation, the Board of Governors agreed that an expert from outside the ESM should lead the exercise to ensure its credibility and independence. Chairperson Dijsselbloem appointed Gertrude Tumpel-Gugerell, the former vice-governor of the Austrian National Bank and a former member of the Executive Board

High-level independent evaluator Gertrude Tumpel-Gugerell

WOLFGANG SCHÄUBLE
Minister of Finance of the Federal Republic of Germany, ESM Governor

"The common currency is a key element of European integration. As such it contributes to the wellbeing of our citizens and our economy. The stability of the euro contributes to the strength of Europe in the world. The ESM delivers an important contribution for a stable monetary union."

of the ECB. She was backed by an evaluation team comprised of ESM staff members, consultants, and external advisors.

Under Ms Tumpel-Gugerell's guidance, an evaluation team of over 15 ESM staff members developed a quantitative and qualitative analysis of the programmes and themes that were common to the ESM/EFSF's intervention in these five countries. The evaluation team also conducted field missions to programme countries and interviewed 79 key experts who either set up these programmes, or managed the crisis in their countries or at the institutions, including at the ESM/EFSF.

The objective of the evaluation, as outlined in the scope agreed by the Board of Governors, was to assess the relevance, effectiveness, and efficiency of each programme. Relevance in this context means the appropriateness of the programme as regards the country's needs and in relation to the institutional mandate given to the ESM/EFSF. Effectiveness is to be measured against the achievement of the objectives outlined in the programme, as agreed by all ESM Members and the beneficiary member. Efficiency is represented by how loans, expertise, and time were converted into results.

ESM/EFSF programmes also inaugurated a new inter-institutional model of crisis management. The institutional set-up of ESM financial assistance, as defined in the ESM Treaty, requires programmes to be conducted in close cooperation with international partners. The European Commission, in liaison with the ECB, is tasked with negotiating a memorandum of understanding detailing the policy conditions that the programme country needs to undertake, known as policy conditionality, in exchange for ESM/EFSF loans. It also requires the IMF to be involved wherever possible, to benefit from its 60-year-long programme expertise and a parallel financing instrument.

The evaluation covers this cooperation with partner institutions, but not the policy conditionality. The institutions responsible for negotiating the policy conditions have already evaluated them in most cases.

The evaluation report does not address the political aspects of the Eurogroup negotiations with respect to EFSF/ESM programmes, which often preceded the decisions taken by the ESM decision-making bodies.

The report, which will be made public on the ESM website, makes recommendations to improve future ESM activities.

PROGRAMME COUNTRY EXPERIENCES

Ireland's economy continued to expand at a very healthy pace in 2016, with a solid performance of domestic growth indicators. The unemployment rate dropped to its lowest level since July 2008 and the public deficit kept falling. In the banking sector, non-performing loan (NPL) reduction lost some momentum in 2016 while profitability decreased slightly. Looking ahead, external uncertainty remains considerable, particularly around Brexit and international tax policies. In a still low interest rate environment, Irish banks, with significant UK exposures, will continue to face a challenging outlook.

Real GDP expanded by 5.2% year-on-year in 2016, making Ireland the fastest-growing economy in the European Union. Although the activities of large multinational corporations in part distort headline growth figures, a number of indicators point to a solid expansion in Ireland's underlying economic activity. In particular, employment rose by 2.9% year-on-year in 2016 and pushed the unemployment rate down to 6.9% in December, the lowest level since July 2008. Private consumption and sectors where foreign-owned multinationals are not prevalent also grew at a healthy pace in 2016.

Inflation remained subdued at -0.2% year-on-year. Meanwhile, house prices continued to rise at an average of +6.4% over the year, a trend that is expected to continue in the near term as the anticipated modest expansion in supply will be insufficient to meet growing demand. Existing macroprudential rules regarding loan-to-income and loan-to-value ratios, however, may somewhat mitigate the upward pressure on house prices.

Fiscal policy was mildly expansionary in 2016. Nonetheless, the general government deficit fell to 0.6% of GDP from 2.0% in 2015. The strong growth in general government revenue, primarily from increased tax revenues and social insurance contributions, underpinned this development. Robust performances in the corporation and capital gains tax categories mitigated below-profile VAT returns.

SVEN SESTER
Minister of Finance of the Republic of Estonia, ESM Governor

"The euro has time and again proven itself as a robust currency fostering a stable monetary climate. The euro has lowered transaction costs and allows its members an easy comparison of prices leading to increased cross-border trade, long-term investments, and economic growth. The single currency has given the euro area Member States a global voice, and together we can build a dynamic monetary union."

Mid-year adjustments to the 2016 budget targets helped absorb higher-than-expected health expenditure. The 2016 headline deficit benefited from a one-off revenue, whilst in 2015 the effect of one-offs, largely related to financial sector supporting measures, was deficit increasing. With growing uncertainties about international tax policies, the Irish authorities have identified the increasing concentration of corporate taxes as a potential fiscal risk.

The government debt-to-GDP ratio is estimated to drop again in 2016 to 75.4%, a level well below the euro area average. Nonetheless, debt measures which are not affected by the recent accounting changes in headline GDP paint a rather different picture. In particular, the debt-to-revenue ratio in Ireland is estimated at about 275% in 2016, well above the euro area average of 198%. The Irish authorities' plan to build a fiscal buffer in the medium term and to reach a 45% debt-to-GDP ratio by 2025 is, therefore, a welcome step.

Ireland maintained solid financial market access in 2016, and investors continued to perceive Irish bonds as closer to core assets than to peripheral ones. Although the ECB started purchasing fewer Irish bonds under its public-sector purchase programme (PSPP) in late 2016, yields still dropped through the year, with the Irish 10-year bond yield declining to 0.7% from 1.1%. Following the credit rating upgrades by Moody's and Fitch last year, to A3 and A, respectively, now all major credit rating agencies assign Ireland an A rating.

The recovery in the Irish banking sector continued last year, but downside risks prevail. NPLs kept falling in 2016, albeit at a slower pace as banks now must deal with the most problematic ones. The strengthening of Irish banks' capital ratios, which are well above the minimum requirements, continued through the year. Yet for those banks included in the European Banking Authority stress tests, results came in below expectations. Decreasing funding costs and impairment charges continued to be the main drivers of profitability. Brexit uncertainties, however, may weigh on this limited profitability going forward, and also on the government's intention to place its banking assets in the private sector.

Under its Early Warning System, the ESM's monitoring shows that Ireland currently faces no difficulty in meeting its loan service repayments. Nonetheless, maintaining a prudent fiscal policy stance in line with the debt target and building up a fiscal buffer would ensure that Ireland will have the scope to pursue growth-supporting countercyclical fiscal policies in future downturns.

MICHAEL NOONAN
Minister of Finance of the Republic of Ireland, ESM Governor

"The euro enhances the living standards of the citizens of all participating Member States. This is achieved inter alia by greater levels of trade, reduced transaction costs, a deepening of the Single Market and increased financial integration within the EU, all of which are facilitated by the single currency."

The Greek economy embarked on a modest growth path in 2016, supported by the successful conclusion of the first review of the ESM assistance programme in May 2016. After the Greek government passed a comprehensive fiscal package in early June, including pension and income tax reforms, the ESM disbursed the second tranche of the programme's financing. However, the economy contracted again late in the year and it continues to face numerous challenges. The Greek government must press ahead with reforms to ensure a successful and timely conclusion to the ESM programme, a return to sustainable market access, and long-lasting growth.

The Greek government is committed to reforms that aim to restore fiscal sustainability; safeguard financial stability; boost growth, competitiveness, and investment. For example, it needs to deregulate the energy market, maintain the greater flexibility achieved in the labour market, and reform the public administration. In May 2016, authorities passed a comprehensive package of fiscal reforms – including an overhaul of the pension and income tax system – with the aim of meeting the ESM programme's 2016–2018 fiscal targets. The package included measures to address any fiscal slippage. In response, the ESM governing bodies approved the disbursement of the second tranche of the ESM programme, starting with a first disbursement of €7.5 billion in June 2016, in part earmarked for the clearance of arrears. They followed up with the approval of a €2.8 billion disbursement in October 2016. Hence, €31.7 billion, of the up-to-€86 billion foreseen for the programme, had been disbursed by the end of December 2016, leaving up to €54.3 billion available until August 2018. This amount could decrease given that bank recapitalisation required less financing than originally foreseen. Should the IMF participate and/or Greece implement policy reforms that enable it to return to market financing before 2018, the final amount could fall further.

The economic recovery in spring 2016 was supported by the completion of the first review of the ESM programme. It also benefited from ebbing uncertainty, easing market conditions, and the arrears clearance programme. But the economy stumbled again towards the end of the year. After real output had expanded for two consecutive quarters on the back of stabilising domestic demand, it reversed course in the last three months of the year. Real GDP contracted amid an increasing fiscal burden, decreasing government spending, and faltering confidence in response to renewed uncertainty over the protracted programme review. Government spending declined while private consumption and business investment slowed markedly. For 2016 as a whole, economic activity stagnated as the negative impact from net trade and budget under-execution offset rising consumer spending, according to the Hellenic Statistical Authority's first annual estimate. The European Commission's Spring Forecast published on 11 May 2017 predicts that GDP will rebound by 2.1% in 2017 and further expand by 2.5% in 2018, while the current account deficit is expected to be at -0.5% and -0.3% of GDP, respectively.

The government posted a primary surplus of 3.9% in 2016, Eurostat said in April 2017, (which translated into 4.2% according to the programme definition), far outpacing the programme target of 0.5% of GDP. This substantial outperformance suggests that fiscal reforms, especially on the revenue side, are bearing fruit. By the end of December, authorities effectively cleared arrears of €3.4 billion in net terms, mostly in the social sector and financed both by ESM funds and the government's own resources. The officially recorded stock of arrears, including tax refunds, amounted to €4.5 billion at the end of 2016. Government debt climbed to 179.0% of GDP in 2016 but is expected to decrease in the short term assuming full and timely implementation of the financial assistance programme.

Following the May 2016 Eurogroup decision to address concerns regarding the sustainability of Greece's public debt, the ESM Board of Governors endorsed a package of short-term debt relief measures on 20 January 2017. The agreed measures consist of: smoothing the EFSF repayment profile under the agreed maximum weighted average maturity; using the EFSF/ESM diversified funding strategy to reduce interest rate risk without incurring any additional costs for former programme countries; and waiving the step-up interest rate margin related to the debt buy-back tranche of the second programme for Greece for the year 2017. According to a statement, the Eurogroup may consider in 2018 a possible second set of measures for the medium term, including a targeted reprofiling of EFSF loans, provided the ESM programme is successfully concluded and the risks to debt sustainability at programme end require such additional measures.

Despite noteworthy programme achievements, Greece continues to face important challenges. Political and economic uncertainty destabilises the business environment. Coupled with a high tax burden and a domestic banking sector plagued by a high stock of NPLs, the overall situation is impeding growth and investment in the private sector. The 2016 reforms to the income tax and pension system were an important step in the right direction. But reconciling necessary medium-term fiscal stability with sustainable growth requires more ambitious initiatives, such as broadening the tax base. Equally, the banking sector must significantly reduce its high NPL ratio, which will help unlock bank lending and support investment, and complete reforms to modernise banks' governance structure. The privatisation programme made some headway in 2016 but its independence from political influence should be enhanced. In the same vein, the government must strengthen the privatisation framework by making the new asset and privatisation fund, the Hellenic Corporation of Assets and Participations, fully operational so that Greece can swiftly proceed with the privatisation programme.

Despite visible signs of recovery, the Greek economy continues to operate in a difficult environment. Any further delays in programme implementation and renewed political uncertainty run the risk of undermining programme achievements and putting considerable strain on the economy. The Greek government – in close cooperation with programme partners – is called upon to address the remaining deficiencies rigorously and lay the necessary foundations for a successful programme conclusion. Meeting these challenges is particularly crucial at this juncture to ensure a smooth transformation of the still fragile recovery into self-sustained long-term growth.

The three financial assistance programmes for Greece

2010 2011 2012 2013 2014 2015 2016 2017 2018

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 the European Commission: €52.9 billion; IMF: €20.1 billion

Grace period and maturity on GLF loans extended to 10 and 30 years from 3 and 5 years, respectively

Interest rate: priced with Euribor 3M with a margin lowered from 300 to 50 basis points 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 was not used by the HFSF and was returned to the EFSF; IMF: €12 billion

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

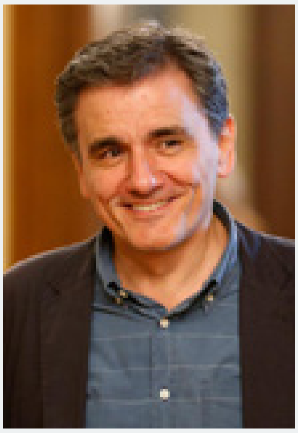
Total amount disbursed: €31.7 billion

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: 0.86% (end March 2017)

Key legislated reforms: VAT, pension, corporate and household insolvency law, out-of-court debt workout, sales and servicing of loans (NPLs), establishment of privatisation fund



EUCLID TSAKALOTOS
Minister of Finance of Greece,
ESM Governor

"The common currency protects Europe from 1930's-style competitive devaluations, which is the last thing Europe would need now. Although the Eurozone's architecture is lacking in a number of respects, the euro can work, if it is seen to work for all its people and regions."

ESM designs and implements short-term debt relief measures for Greece

ESM launches short-term measures to reduce interest rate risk for Greece.

The ESM launched a series of short-term measures in 2017 designed to improve debt sustainability for Greece. These so-called short-term measures were agreed by the euro area finance ministers, the Eurogroup, on 5 December 2016 and by the Boards of Directors of the EFSF and ESM on 23 January 2017.

The measures will cut Greece's gross financing needs by almost five percentage points by 2060.

When implemented in full, these short-term measures could reduce Greece's debt-to-GDP ratio by around 20 percentage points and gross financing needs (GFN) by almost five percentage points in 2060. These estimates are based on the baseline assumptions of the European institutions in December 2016, and should be taken with caution given the high uncertainty attached to the long horizon of the analysis.

The Eurogroup also approved further measures in principle, if required.

In its statement of 25 May 2016, the Eurogroup mentioned a possible second set of medium-term measures, following Greece's successful conclusion of the ESM programme in August 2018, if needed. The Eurogroup has also agreed a contingency mechanism to ensure long-run debt sustainability, if needed. The possible medium- and long-term measures can be phased in progressively if necessary to meet the agreed benchmark for GFN.

Overview of the short-term measures

Measure 1: Smoothing the EFSF repayment profile under the current weighted average maturity

Under the EFSF Master Financial Facility Agreement with Greece, the maximum weighted average maturity was set at 32.5 years. By 2016, however, the final weighted average maturity dropped to 28.2 years mainly due to a €10.9 billion early repayment in February 2015. With this measure, the maturity will now be brought back up to 32.5 years. This measure spreads out over several years a number of repayment humps that would have been due in the 2030s and 2040s, thereby mitigating Greece's refinancing risk. In addition, it facilitates debt service payments on non-EFSF/ESM Greek debt by smoothing the overall Greek debt profile (Figure 12).

Measure 2: Using the EFSF/ESM funding strategy to reduce interest rate risk without incurring any additional costs to former programme countries

In consultation with its Members, the ESM designed three non-mutually exclusive short-term schemes to improve debt sustainability. The proposed schemes provide the largest possible benefit for Greece without subjecting former programme countries to additional costs.

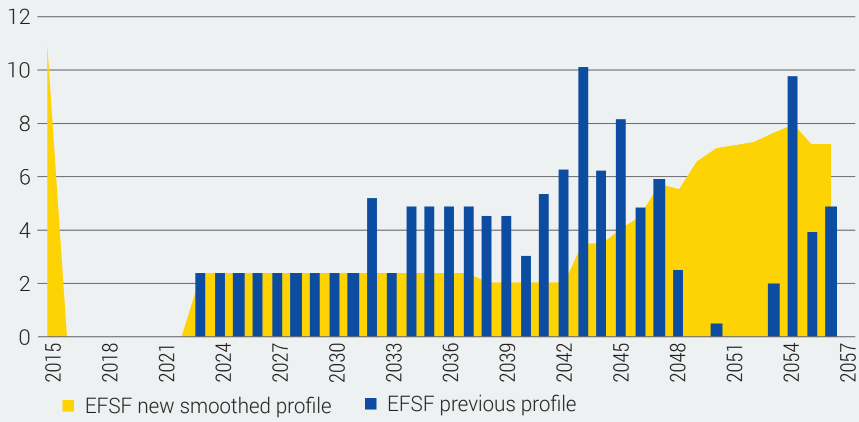
- **Scheme 1: Bond exchange.** To recapitalise banks, the EFSF/ESM provided loans to Greece worth €42.7 billion. The stability funds disbursed these loans in the form of floating-rate notes. Under this scheme, the EFSF/ESM will exchange most of these floating rate notes with fixed interest rate instruments and extend their maturities. To do so, the ESM will issue long-term fixed-rate notes through cashless transactions, which will be held by the banks temporarily, as well as bonds, thereby funding in stages the repurchase of the bank-held floating rate notes.

- **Scheme 2: Swap arrangements.** Swapping floating for fixed interest rate cash flows reduces the variability of interest rates associated with ESM loans. By fixing the interest rate for part of the ESM loan, Greece will have more certainty and predictability on the future stream of interest rates it must pay. The magnitude of the benefits will vary depending on the rate, the maturity, and the size of the swap transactions that the ESM can execute on the market.

- **Scheme 3: Matched funding.** The ESM will charge a fixed rather than a floating rate on part of future disbursements to Greece. Under the current programme assumptions, the ESM expects to disburse a further €30 billion to Greece until mid-2018. With matched funding, the ESM will issue long-term fixed-rate bond issuances that closely match the maturity of the Greek loans.

The implementation of these three schemes is subject to market conditions. The ESM will assess the feasibility and benefits of transactions for Greek debt sustainability on an ongoing basis.

Figure 12
Indicative EFSF loan re-profiling under the current weighted average maturity
(in € billion)



Source: ESM calculations

Measure 3: Waiving the step-up interest rate margin related to the debt buy-back tranche of the second Greek programme for the year 2017

In December 2012, the EFSF provided €11.3 billion to finance Greece's debt buy-back operations. This instalment was charged with a 0 basis point margin but provided for a step-up margin of 200 basis points as of 1 January 2017. The third short-term debt measure waives this step-up margin for the year 2017.

Impact of the short-term measures

The bond exchange and interest rate swaps will provide Greece with the most relief.

All short-term debt measures have a positive effect on Greek debt dynamics. The short-term measures are expected to reduce the overall debt-to-GDP ratio by 20 percentage points in 2060 and the GFN ratio by five percentage points.[2] The bond exchange under scheme 1 (back-to-back extension) should deliver the greatest benefits as it affects the largest portion of Greek debt. This scheme will reduce both the debt-to-GDP and the GFN-to-GDP ratios by 2060. The other two measures have a broadly similar effect; both could yield a reduction of the debt-to-GDP level of around seven percentage points by 2060. They each lower the GFN ratio by 1.5 percentage points over that time period.

The debt measures will also help the Greek government secure more favourable market lending rates.

The smoothing of the EFSF repayment profiles lowers the debt ratio by more than three percentage points and the GFN ratio by almost one percentage point by 2060. The cancellation of the 2017 debt buy-back instalment step-up margin has the least impact; it decreases 2017 interest payments by around €220 million. Matched funding of future ESM disbursements will bring additional benefits for long-term Greek dynamics. Finally, these measures will have a knock-on effect; they will help the Greek government secure more favourable market lending rates.

Seen from a net present value perspective, the short-term measures reduce Greece's overall debt burden by some 8.7% of Greek GDP.

From a net present value (NPV) perspective, the short-term measures also reduce the overall debt burden by around 8.7% of Greek GDP. The NPV approach consists of discounting the difference between the future cash flows of the EFSF and ESM loans before and after the short-term measures. The discount factor reflects the weighted average cost of financing total Greek debt. The NPV gains increase if the second round effect of the short-term measures – lower market refinancing rates for Greece – are taken into consideration. The final overall impact of these measures, however, depends on the size and timing of market transactions and the combination of schemes. In addition, the effects are sensitive to the assumptions underlying the debt sustainability analysis.

[2] The estimated impact of the short-term measures is based on the baseline DSA assumptions of the European institutions in December 2016.

LUIS DE GUINDOS JURADO
Minister of Economy, Industry and Competitiveness of the Kingdom of Spain, ESM Governor

"The euro is not just a currency but also, fundamentally, a political undertaking. The euro has proven to be the main tool of cohesion we have, for it changes the daily lives of Europeans by facilitating the free movement of people, culture, education, goods, and services."

Debt sustainability: focus on flows

The EFSF/ESM provide loans to euro area countries that have lost sustainable market access or suffered shocks to their banking systems when these problems could spill over to other countries and even destabilise the entire single currency area. The EFSF/ESM have lent substantial funds in six programmes to five euro area Member States – Ireland, Portugal, Greece (second and third programmes), Spain, and Cyprus – and proactively monitor their repayment capacity.

The ESM extends loans to countries in difficulty and monitors their repayment capacity.

Key to measuring a country's repayment ability is the analysis of the sustainability of the country's debt. Different institutions vary in the metrics they use to evaluate sustainability. Clearly, no single metric will deliver a fully reliable country-specific risk assessment of debt sustainability. The ESM's view on how to best calculate debt sustainability is that the analysis should go beyond the traditionally used debt stock metrics, and link sustainability to debt-flow metrics such as a country's forthcoming financing needs. Indeed, the ESM's flow approach to assessing sustainability is also gaining traction at the political level in assessing the situation of Greece.

The ESM focuses on debt-flows to analyse a country's ability to repay.

In line with the ESM's view, which has long argued against employing only debt stock metrics when assessing short- and medium-term challenges to debt sustainability, the debate now focuses more on the adequacy of GFN, a flow metric that captures forthcoming financing needs. GFN adds up the following elements: interest payments, principal repayments, and the primary deficit. The rationale for using this comprehensive flow metric is that funding shortages occur when there is a mismatch between GFN and financing sources. As a result, the larger the GFN, the harder it is for the sovereign to fill the gap. Thus, while large debt stocks could signal solvency problems, excessive GFN may indicate a heightened risk that the debtor country cannot cover upcoming payment obligations. Linking the concepts of solvency and illiquidity to those of stock and flow metrics is perfectly logical, but the question remains what particular combinations of debt stock and flow features negatively affect debt sustainability.

Gross financing needs are a key metric in analysing a country's repayment ability.

Given the different perspectives, ESM research puts the stock and flow perspective to the test, investigating how the two affect sovereign risk in the eyes of financial markets. The study uses data on sovereign spreads, general government GFN, and debt stocks series for 23 European Union countries from 1995 to 2016.[3] To understand the impact of stocks and flows on sovereign risk it is useful to look at them not only individually but also jointly. Market participants may look at them in com-

GFN increase more than proportionally as debt stocks rise for euro area countries.

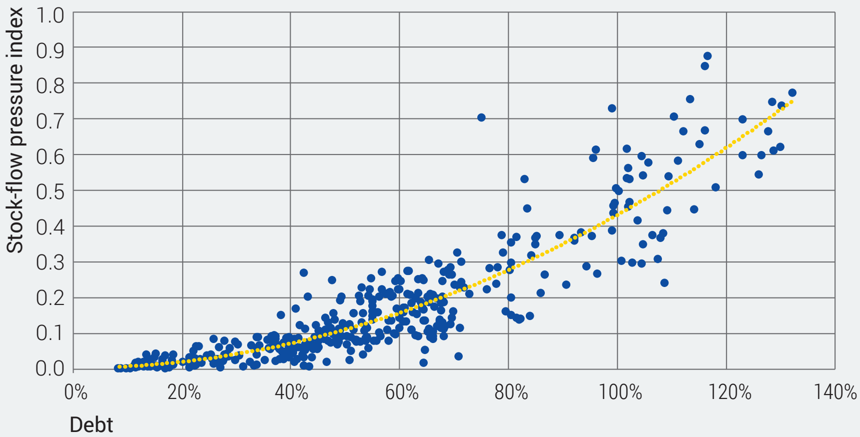
[3] See ESM Working Paper No. 24, Gabriele et al. (2017), "Debt Stocks Meet Gross Financing Needs: A Flow Perspective into Sustainability".

bination when assessing a country's creditworthiness. The authors therefore construct a stock-flow pressure (SFP) index which combines the two measures.[4] The higher the SFP index, the more the worrying stock and flow debt features coincide and the more disquieting the situation. Figure 13 plots the SFP index against the debt stock. The explosive path of the data cloud reveals that GFN increases more than proportionally as debt stocks increase. This highlights the importance of monitoring GFN as the debt stock increases, which is particularly noteworthy since the ESM must address the problems of highly indebted countries.

When debt ratios exceed 60%, GFN increases lead to widening sovereign spreads.

To determine the impact of this metric on credit risk, the study looks into the drivers of 10-year sovereign spreads. Evidently there is a feedback loop here: countries perceived as riskier face higher spreads, and in turn higher costs to borrow funds in the market to repay their debt.[5] The results strongly show that both flow and stock metrics are relevant to spread movements. Importantly, however, GFN become increasingly relevant in determining sovereign risk as debt stocks grow. For mild debt stocks increases in GFN are not a concern, but when debt ratios exceed 60%, increases in GFN lead to larger sovereign spreads and more expensive borrowing country interest rates.

Figure 13
Stock-flow pressure and debt



Notes: The stock-flow pressure index is rescaled between zero and one. Debt is in % of GDP.
Source: ESM calculations based on European Central Bank data

Debt stocks are perceived as riskier when GFN are high.

For instance, if a country has a debt-to-GDP ratio of 100%, an increase of one percentage point in GFN translates into an increase in the spread of 10 basis points, all else being equal. Similarly, the same increase in GFN with debt stock at 80% would translate into a five basis point increase in spreads. Equally interesting is the effect of increasing the debt stock by 1% of GDP. Figure 14 plots this effect on spreads at different debt levels. If GFN is above 20%, which the IMF identifies as a critical level, every 1% rise in the debt stock pushes spreads out by more than four basis points. But the impact of the debt level in driving up sovereign spreads is more attenuated than for GFN for levels generally observable in the euro area.

4 The authors constructed the index by multiplying, for each country/year pair, debt stock (as % of GDP) and GFN (also as % of GDP), and normalised it to lie between zero and one.

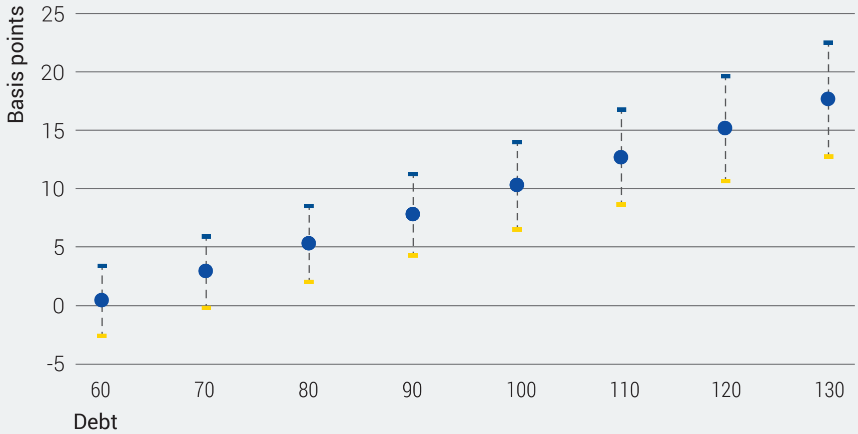
5 The baseline econometric specification, in addition to the measures of debt stock, GFN and the SFP Index, also included real GDP growth, change in debt, and a set of global factors (VIX, world growth and the US 10-year yield). The key coefficients are those quantifying how stock and flow debt metrics, including the compounding SFP Index, translate into risks to sustainability, as measured by sovereign spreads. Our main specification is

$$Spread_{it} = \alpha + \beta \cdot \frac{Debt}{GDP}_{it-1} + \gamma \cdot \frac{GFN}{GDP}_{it-1} + \delta \cdot SFPI_{it-1} + \theta \cdot Controls_{it-1} + \mu_i + \varepsilon_{it}$$

Using these estimates, it is also possible to identify a threshold for debt above which increases of GFN add to the country's perceived solvency risk. This threshold hovers around 60% of GDP. Armed with this result, another relevant experiment is to split the effect in two: when debt is above 60% of GDP, and when debt is below. The results of this alternative model are presented in Figure 15. Again, if the debt stock is above 60% of GDP, sovereign spreads may increase by six basis points for every one percentage point increase in GFN.

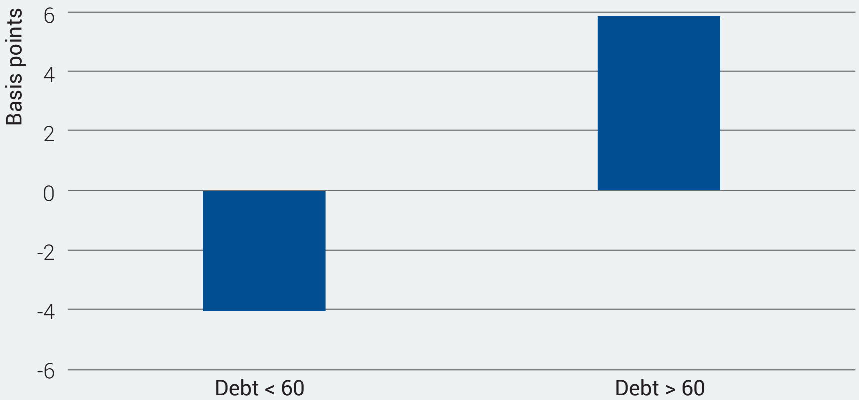
If debt is above 60% of GDP, each percentage point increase of GFN leads to additional financing costs.

Figure 14
Impact of gross financing needs on spreads, by debt levels



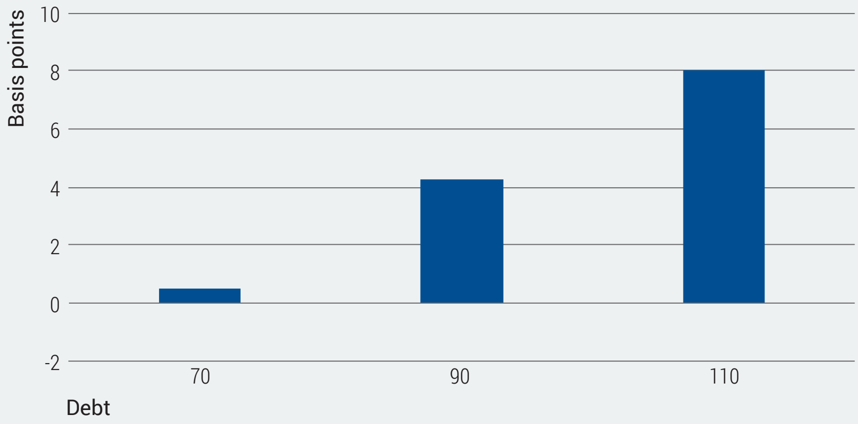
Notes: Debt is in % of GDP. The graph presents 10% error bands.
Source: ESM calculations based on European Central Bank data

Figure 15
Impact of gross financing needs on spreads
(high vs. low debt)



Notes: Debt is in % of GDP. The marginal effect of gross financing needs on spreads when debt is below 60% is statistically zero.
Source: ESM calculations based on European Central Bank data

Figure 16
Impact of debt amortisation on spreads, by debt levels
(in % of GDP)



Source: ESM calculations based on European Central Bank data

The debt repayment component of GFN is the key driver of spread widening.

Finally, the results indicate that the debt repayment component is the main driver of debt features. Figure 16 shows that the results are similar to the findings obtained when using overall GFN. According to these estimates, at high debt levels, a one percentage point increase in debt repayments can add more than five basis points to the sovereign spread.

Research findings confirm that the flow features of public debt are key to repayment.

These findings have two important implications. First, they reinforce the need to closely monitor debt flows especially for countries with debt levels above the 60% benchmark established by the European Treaty. Second, the results indicate that the lending terms of ESM loans, which strongly reduce financing needs because less debt roll-over is required, keep spreads narrow and help make market finances accessible and affordable.

Robust domestic demand and a resilient external sector kept GDP growth well above the euro area average in 2016. Despite political uncertainty, the headline public deficit continued falling in 2016, mostly benefiting from cyclical improvement in activity. The Spanish treasury's market access remained healthy in 2016, and the country completed its funding programme successfully. The banking sector showed stability, although profitability remained lacklustre, as elsewhere in Europe.

Spanish GDP, on its third consecutive yearly expansion, grew 3.2% in 2016 (the same rate as in 2015), outperforming most forecasts. Domestic demand, supported by private consumption, drove growth. For the first time since the recovery began, the external sector also contributed positively. Despite weak global trade, exports grew robustly, while imports of goods and services slowed. Low oil prices helped to amplify the improvement in the trade balance, leading to an increase in the current account surplus to 2.0% of GDP. Spain's international debtor position, which remains high, fell during 2016 and is expected to continue declining given a sustained surplus in external accounts. Low energy prices kept inflation subdued in 2016 but it accelerated slightly to -0.3% from -0.6% in 2015. Due to rising energy prices, headline inflation has gained momentum since the end of 2016, while underlying inflation has remained subdued, with food prices offsetting the increase in services inflation.

The robust activity supported strong job creation, although the participation rate fell to a seven-year low. Still, employment growth remained solid at 2.7%, helping to cut the unemployment rate to 18.7% by year-end 2016. Despite substantial private non-financial sector deleveraging (50 percentage points since its peak), private debt-to-GDP continued above the euro area average. Looking forward, the economy is projected to slow as low oil prices and expansionary economic policies fade.

Fiscal performance improved in 2016. The general government deficit dropped to 4.5% of GDP in 2016, a reduction of 0.6 percentage points from 2015, below the new target of 4.6% under the Excessive Deficit Procedure.[6] The government deficit excluding one-off transactions amounted to 4.3% of GDP. Fiscal consolidation was driven by strong growth, savings related to favourable financing conditions, and the new measures introduced following the 2016

[6] On 12 July 2016, the Council of the European Union decided that Spain had not taken effective action to correct its excessive deficit. After the national authorities' response, the Council agreed to forego a fine. In addition, the Council granted Spain two additional years to correct its excessive deficit, setting 2018 as the deadline.

MICHEL SAPIN

Minister for the Economy and Finance of the French Republic, ESM Governor

"The euro is a long-term economic and political project like no other. It rapidly became the second most used reserve currency internationally and acquired a strong credibility worldwide as well as a robust domestic support. Despite significant economic shocks over the years, its main outcomes are tremendous. For our economies, it caters for the need of monetary stability and full price and cost transparency, which support trade and investments while avoiding uncooperative exchange rate policies within the Union. For our 340 million citizens, the euro is now one of the main concrete realisations of the European project, thanks to which one travels freely in 19 countries with the same coins in hand. Yet the euro remains a work in progress, with some way to go on financial, fiscal, and political integration, dealing with macroeconomic imbalances within the zone, and strengthening cohesion and democratic legitimacy. But these challenges should only fuel further our commitment to protect and strengthen this common public good."

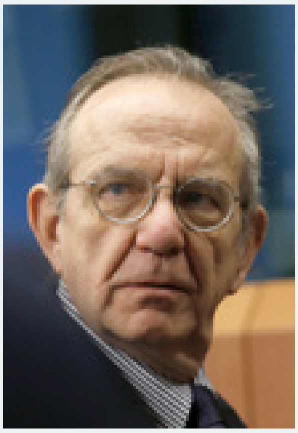
European Commission deficit recommendation.[7] The latter more than offset a tax revenue drop, related to the 2015–2016 fiscal reform. Public debt declined to 99.4% of GDP in 2016 from 99.8% in 2015.

The Spanish treasury successfully completed its 2016 funding programme in a low interest rate environment with both lowered funding costs and extended duration at issuance. The 10-year bond yield fell by 34 basis points in 2016, bucking a widespread sell-off in European sovereign bonds from September.

Spanish banks' financial condition was stable thanks to better asset quality, strong funding, satisfactory capitalisation, and its ongoing restructuring. As elsewhere in Europe, Spanish banks' profitability has remained weak due to the challenging environment. Banks' domestic net profits declined by one third in 2016, stemming from declining net interest income and increasing litigation costs that could not be offset by a drop in impairment charges. Although credit stock is decreasing, expanding bank lending to small and medium-sized enterprises and consumer credit supported the economy. Asset quality improved, albeit unevenly. NPL stock decreased by 13.4% year-on-year in 2016, which together with a fall in credit (-3.8%), led to a one percentage point decrease to 9.1% in the NPL ratio. Capital ratios remained slightly below the European average but above regulatory requirements, and banks performed satisfactorily in the 2016 EBA stress test. The government aims to merge the two state-owned banks to maximise the recovery of state investment.

Since the sixth post-programme mission in October 2016, economic and financial indicators have performed positively. Under its Early Warning System, the ESM continued to assess positively Spain's ability to honour its ESM loan service obligations. Additional early repayments of €3 billion are planned in 2017, leading to a total repayment of 23.3% of the programme by the end of 2017. Nevertheless, given high debt levels, a credible fiscal strategy and strong reform momentum are key to reducing vulnerabilities.

7 On 9 March 2016, the European Commission issued its Recommendation regarding measures to be taken by Spain in order to ensure a timely correction of its excessive deficit.



PIER CARLO PADOAN
Minister of Economy and Finance of Italy, ESM Governor

"The euro has played a central role in European integration. Today the single currency continues to serve as a foundation of the euro area but the economic governance is falling short of the fundamental goals of fostering convergence among Member States and promoting growth, employment, and inclusion. Persisting fragmentations and a rapidly evolving international scenario require an urgent collective response based on credible reform efforts and effective risk sharing."

CYPRUS

The Cypriot economy maintained strong momentum in 2016, the year it successfully concluded its ESM financial assistance programme, with growth mainly driven by domestic demand. Favourable economic conditions and advances in other key areas, such as on the fiscal side, helped it to also exit the EU's Excessive Deficit Procedure (EDP). The banking sector's performance continued to improve, albeit at a slower pace. The persistently high level of NPLs is still weighing on banks' outlook.

Cyprus experienced solid economic growth in 2016. GDP grew at 2.8%, better than the most recent forecasts had expected. This positive surprise stemmed largely from domestic demand growth of 3.9%. The labour market also extended its recovery. The unemployment rate declined to 13.3% in December 2016 from 16.6% in December 2014 but it still exceeded the 9.6% euro area average in December 2016. Although youth unemployment fell steadily, it remains too high. Low oil prices helped keep inflation negative.

Fiscal performance improved in 2016. The Cypriot primary surplus climbed close to 3% of GDP from 1.7% in 2015, leading to a balanced headline general government position compared to a deficit of 1.1% of GDP in 2015. Cyprus therefore exited the EDP, and re-entered the preventive arm of the EU stability and growth pact. The high government debt-to-GDP ratio slightly increased to 107.8% in 2016 from 107.5% in 2015. Some reforms have been postponed again, however, in particular those related to privatisation.

The banks are well capitalised and the liquidity position is improving. Modest internal capital generation in 2016 slightly strengthened capitalisation further, while the very high level of NPLs still weighed on profitability and outlook. Despite the high stock, NPLs fell and are expected to continue trending lower. The necessary legal framework to reduce NPLs has now been put in place, however, actual restructurings slowed over the year. The gradual improvement in economic performance combined with the recovery of the banking sector, means the privatisation process of the currently state-owned bank could start in mid-2017, following the full completion of the listing requirements. Despite the promising developments, new regulatory requirements pose a challenge to banks' outlook.

Robust economic growth and continuing fiscal consolidation contributed to sovereign financial market access and allowed Cyprus to exit the ESM programme in 2016 without a follow-up financial arrangement. The funding costs of the Cypriot government edged lower. For instance, despite the widespread bond sell-off in the euro area sovereign market, the yield of the Cyprus 10-year bond declined to 3.5% at the end of 2016 from 3.8% a year earlier. Over the programme period, Cyprus also built safe cash buffers and achieved a very sound maturity profile. While its credit ratings remain below investment grade, credit rating agencies' outlooks were universally positive. Looking forward, Cyprus's complete and successful return to financial markets will hinge largely on its determination to maintain its prudent fiscal policy, bank restructuring, and structural reforms.

Cyprus is bearing the fruit of reforms introduced over recent years. The country needs, however, to restart the structural reform momentum, consolidate improvements, and promote Cyprus's international competitiveness to attract investment. Prudent fiscal policies are particularly important now as the economy recovers. Further improving public sector efficiency and ensuring labour market flexibility will strengthen Cyprus's long-term growth potential and its attractiveness as an investment destination. Reunification of the country would also benefit investment and growth.

PORTUGAL

Portuguese growth accelerated in the second half of 2016, although annual GDP growth was slightly lower than in 2015. Potential growth remained mild. Import demand resulting from private consumption and equipment investment prevented net exports from turning positive. The Portuguese government has corrected the excessive fiscal deficit. Efforts to entrench prudent fiscal policies to put the high debt stock on a downward trajectory must be strengthened. The Portuguese banking system remains vulnerable due to low profitability and high NPLs, however, the recapitalisation of the two largest banks represented a positive development.

In Portugal, real GDP growth slowed to 1.4% in 2016 from 1.6% in 2015. Economic activity remained slow in the first half of the year, and decelerated overall for the year despite a marked acceleration in the second half. Construction investment declined while private consumption, private investment in non-financial corporations, and exports drove growth. The rise in the minimum wage continued to support consumer spending, but increasing labour costs may put at risk past competitiveness gains. Imports due to buoyant domestic demand counterbalanced external demand for Portuguese goods and services. Helped by a smaller deficit in primary income, the current account surplus increased to 0.8% of GDP.

The government deficit more than halved to 2.0% of GDP in 2016 from 4.4% in 2015. Excluding one-off measures, it fell to 2.3%. The budget deficit was lower than the target set by the European Council and it was the first time that it has fallen below the Stability and Growth Pact's 3% threshold since the Pact was agreed in 1997. Hefty expenditure reductions, notably for public investment, compensated for lower-than-expected revenues.

Government debt increased to 130.4% of GDP in 2016, which is only marginally lower than the peak of 130.6% recorded in 2014. However, the increase stemmed principally from debt issuance for a capital investment in the state-owned bank Caixa Geral de Depósitos (CGD), the largest bank in the country, as agreed with the European Commission. The state's cash position improved, increasing to around €10 billion, or 5.5% of GDP, at the end of 2016.

During most of 2016, Portugal retained good access to capital markets at advantageous terms amid episodes of volatility and a gradual increase in market yields. Portugal's economic performance, the ECB's monetary policy operations, and the international environment all influenced the government bond market. The 10-year bond yield stood at 3.7% at the end of 2016, with the spread vis-a-vis the German Bund increasing by 167 basis points over the year. Portugal diversified its funding sources through retail market issuances and realised interest savings, the latter by completing the planned early repayment of half of its IMF loan by early 2017. It also built up its liquidity buffer – now equal to half of its projected funding needs – which should not be reversed.

The banking sector still remains vulnerable but fundamentals are improving. The average capital level stood at 11.4% of risk weighted assets (CET1 ratio) as of December 2016. Capitalisation has, however, increased since then with foreign investors' €1.33 billion capital increase of Banco Comercial Portugues (BCP) and the €3.9 billion recapitalisation of CGD. Additionally, BPI reduced its risk profile by decreasing its exposure to Angola. Profitability fell significantly in 2016 compared to the previous year while NPLs are still high. Novo Banco, the bank emerging from the resolution of Banco Espirito Santo in 2014, is still in the process of being sold by the Resolution Fund, with the sale expected by August 2017 at the latest.

The Early Warning System suggests that reduction of the large public debt stock remains challenging, in particular if interest rates increase while potential growth remains weak. To boost long-term growth, Portugal should continue to take the measures promoting competitiveness recommended by the European Council. Portugal should also continue to address the high NPL stock on the banks' balance sheets. Debt sustainability furthermore calls for highly prudent fiscal policies over an extended period in line with the requirements under the European fiscal governance framework.

HARRIS GEORGIADES
Minister of Finance of the Republic of Cyprus,
ESM Governor

“In times of great uncertainty, the euro has proven to be our main defence, especially for the smaller Member States. Macroeconomic stability, price transparency, and an economic environment with low interest rates have benefited both the euro area countries as a whole and also each individual citizen.”

Regaining competitiveness: programme country experiences

The five euro area countries that requested financial assistance from the EFSF or ESM suffered from a number of problems. One key weakness that led some of them down the wrong path economically: a structural imbalance in their growth model. This model relied strongly on domestic demand fuelled by unsustainable government spending, large wage increases, and surging private indebtedness funded by foreign creditors. High wage rises combined with low productivity growth made domestic goods and services more expensive and less competitive on international markets.

In the decade before the adjustment programmes started, all five programme countries experienced a sharp decline in international competitiveness.[8] While wage growth also outstripped productivity growth in the euro area as a whole, the increase in unit labour costs was more pronounced in most of the programme countries (Figure 17). Spain and Cyprus passed on a larger share of these climbing nominal labour costs to prices[9] than their 36 trading partners and competitors,[10] while prices in Ireland and Greece remained broadly unchanged relative to their trading partners. With the exception of Portugal, the increase in nominal unit labour costs relative to trading partners exceeded relative price rises. Hence, labour became more expensive in real terms before the crisis, reducing profitability in an international comparison (Figure 19). The appreciation of the euro contributed to losses in price competitiveness vis-à-vis non-euro area countries.

The five EFSF/ESM programme countries had a common pre-crisis problem: wage growth outpaced productivity gains.

In a currency union, the toolkit available to countries to regain competitiveness no longer includes currency depreciation. Instead, the currency union members need to produce goods and services of higher quality, produce more efficiently, or if this does not suffice, reduce labour costs relative to competitors as part of a rebalancing process – these measures contribute to a so-called internal devaluation.[11] The first two measures target structural improvements, which typically require a longer implementation period. With the latter, countries could, in principle, take action more quickly; however, acting on wages, while necessary during the crisis period, can be

Enhancing productivity is the key to restoring competitiveness in a currency union, but in the short-term wage cuts may be inevitable.

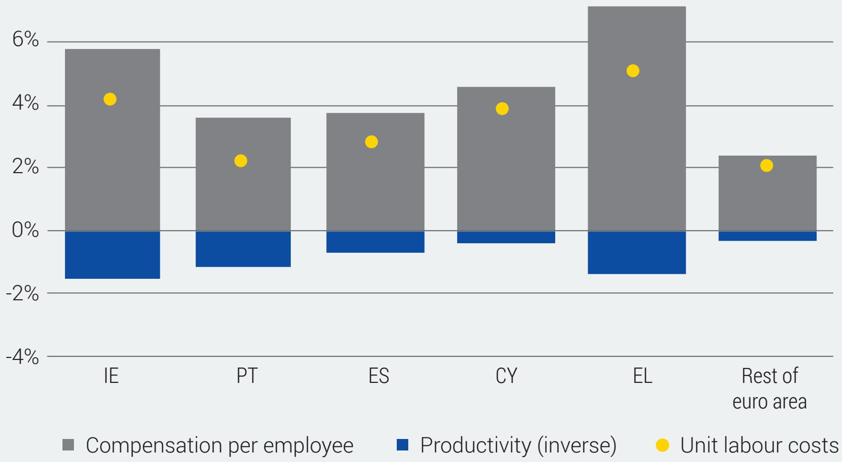
[8] Spain's programme was focused on financial sector recapitalisation, and therefore did not include explicit fiscal and structural conditionality. Instead, the Memorandum of Understanding foresees the regular monitoring of fiscal progress on exiting the Excessive Deficit Procedure and of structural reforms to correct macroeconomic imbalances identified within the framework of the European Semester.
[9] As measured by the GDP deflator.
[10] IC37 as defined by the European Commission: EU28 + nine other industrial countries: Australia, Canada, United States, Japan, Norway, New Zealand, Mexico, Switzerland, and Turkey.
[11] Further details on the adjustment mechanisms in a monetary union can be found in IMF (2014), Adjustment in Euro Area Deficit Countries: Progress, Challenges, and Policies, SDN/14/7, pp. 10 et seqq.

socially and politically costly. This may require reforms because minimum wages, sectoral wage agreements, or the degree of centralisation of wage negotiations can hamper a lowering of wages or decelerated wage rises.[12]

All five countries have made significant gains in price competitiveness since their programmes started.

The EFSF and ESM economic adjustment programmes for Ireland, Greece, Cyprus, and Portugal took these factors into account. The programmes encouraged countries to foster a flexible business environment and remove distortions from product and labour markets. They adopted various approaches to achieve internal devaluations: reductions or freezes of minimum wages or reconfigurations of the wage-setting process.[13] As a result, these four countries accomplished significant price competitiveness gains. This was also the case for Spain which, even outside a full economic programme, benefited from the implementation of significant structural reforms.[14] While in the euro area as a whole productivity growth has been below nominal wage growth since 2009, the reverse was true in all programme countries. In Ireland and Spain, the decline in nominal unit labour costs was driven by productivity improvements, albeit in Spain these partly resulted from a significant fall in employment. In Cyprus and Greece, the adjustment took place predominantly via marked reductions in compensation per employee (Figure 18). In Portugal, the overall decline in unit labour costs was more limited than in the other programme countries but quite pronounced when compared with trading partners and competitors.

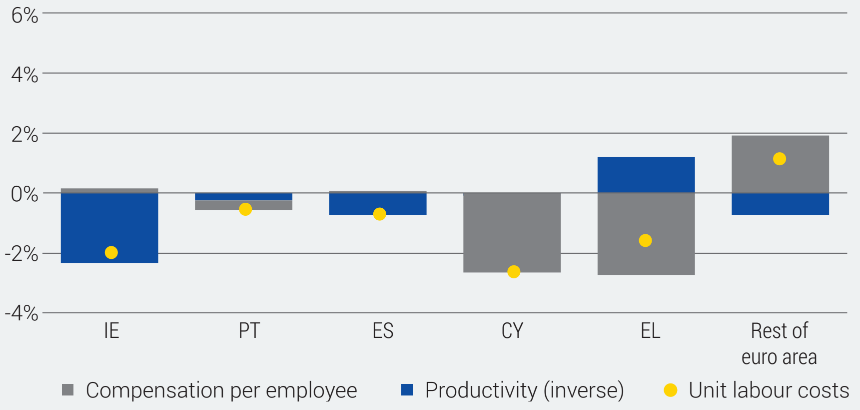
Figure 17
Average annual unit labour cost growth from 2000 until year before programme start



Note: Euro area data from 2009.
Source: Ameco

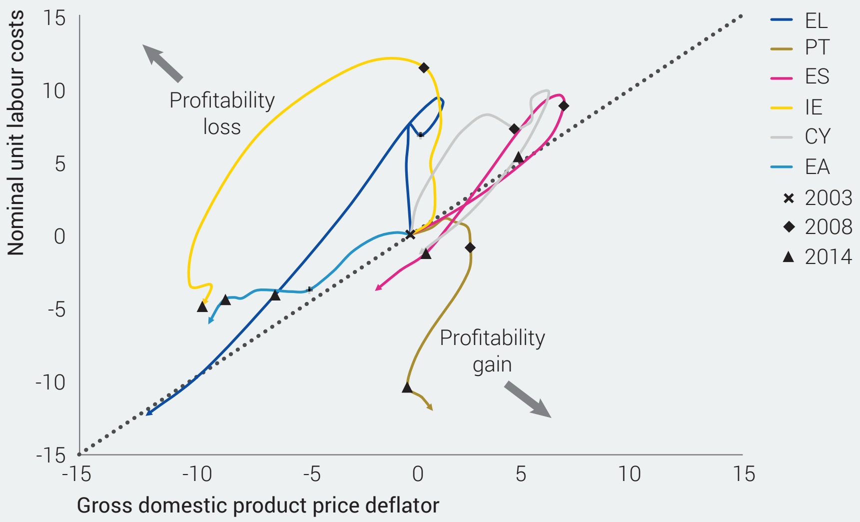
12 Econometric analysis by the Bundesbank (2016) provides evidence of downward nominal wage rigidity in the euro area during the crisis period 2010 to 2013.
13 Further details on the policy measures of the financial assistance programmes can be found in ESM (2016), ESM 2015 Annual Report.
14 This report focuses on price competitiveness developments. The five programme countries also improved in non-price competitiveness, albeit in different areas. The OECD's Product Market Regulation index and Employment Protection Legislation index as well as the World Bank's doing business index overall suggest some improvements in Greece, Portugal, and Spain since the onset of the crisis. The European Innovation Scoreboard indicates improvements since 2013 only for Ireland and Portugal, and for Greece before 2014. The World Economic Forum's Global Competitiveness Report overall records some improvements in Ireland, Portugal, and Spain since 2010.

Figure 18
Average annual unit labour cost growth from year before programme start until 2016*



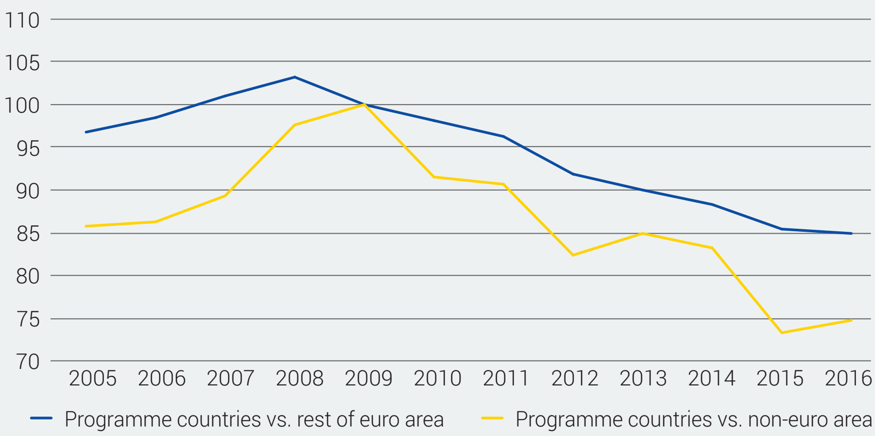
Note: *Ireland data until 2014.
Source: Ameco

Figure 19
Real unit labour costs relative to trading partners
(2003=0)



Note: Three-year moving averages, performance relative to 37 industrial countries.
Source: Ameco

Figure 20
Real effective exchange rates for programme countries in the aggregate
(deflated by unit labour costs, 2009=100)

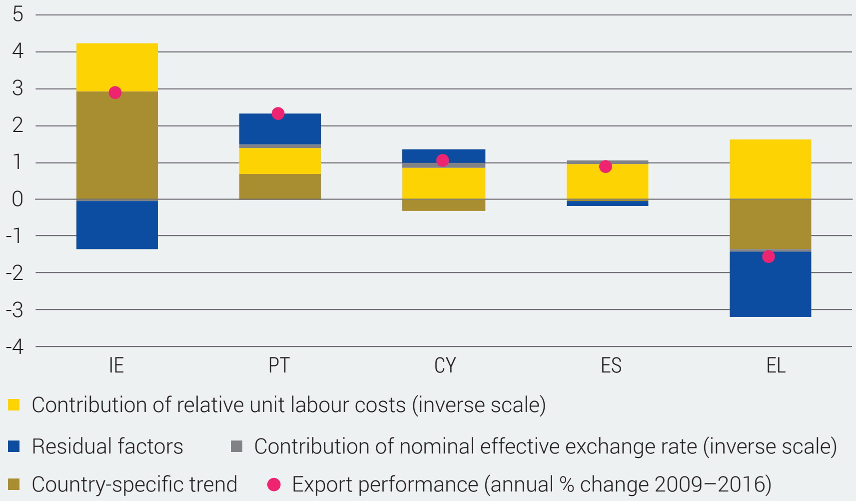


Source: ESM calculations based on Ameco data

In 2016, nominal unit labour costs climbed in three out of five programme countries.

The euro area's overall nominal unit labour costs increase did little harm as competitors also suffered from rising unit labour costs (Figure 19). Prices charged by euro area firms, however, rose less than in the other countries, cutting into their profit margins with a resulting rise in relative real unit labour costs. In contrast, all programme countries managed to reduce their real relative unit labour costs and thereby secure a comparatively more profitable business situation since the start of their programmes. Taking all programme countries together, the more pronounced decrease in relative nominal unit labour costs suggests a marked improvement in price competitiveness over other euro area countries since 2008. To complement the assessment of the competitive stance of the programme countries vis-à-vis non-euro area countries, changes in the exchange rate have also been taken into account (Figure 20). The euro's depreciation prompted an even stronger improvement in the real effective exchange rate (based on unit labour costs) vis-à-vis the rest of the world. Compared to each other, the competitive position of the programme countries did not change as much, which reflects the simultaneous internal devaluation process. Figure 20 also shows, however, that the improvement in the programme countries' real effective exchange rate has been bottoming out since 2015. In 2016, nominal unit labour costs rose in three out of five programme countries.

Figure 21
Impact of unit labour costs and nominal effective exchange rate on programme countries' export performance since 2009



Note: Export performance, unit labour costs, and nominal effective exchange rate (NEER) are calculated relative to 37 industrial countries.
Source: Ameco

Research suggests that a 1% decrease in nominal relative unit labour costs translates into a 0.5% increase in export performance.

ESM internal research supports the conclusion that relative unit labour cost improvements boost export performance.[15] According to the results of a statistical analysis of 11 euro area countries, a 1% decrease in nominal relative unit labour costs translates into a 0.52% increase in export performance, which can be interpreted as a gain in export market share.[16] The programme countries' shares in international export markets have benefited decisively from labour cost reductions compared to their

[15] Export performance growth is defined as the difference between export growth and the growth of export markets. See also European Commission (2017), European Economic Forecast Spring 2017, Institutional Paper 053.

[16] Export performance, unit labour costs, and the nominal effective exchange rate (NEER) are calculated relative to 37 industrial countries. The horizon for Ireland refers to 2007–2014 to adjust for a break due to data revisions. Contributions to export performance are calculated based on the coefficients -0.53 for relative unit labour costs, -0.29 for NEER and on fixed effects (country-specific trend), stemming from a panel OLS regression with robust standard errors, explaining export performance growth through contemporaneous relative unit labour costs and NEER growth between 2000 and 2016 for the 12 countries that joined the euro area up until 2001, excluding Luxembourg. The regression has an R^2 of 16% and the coefficients are significant at a 1% level.

trading partners and competitors since 2009 (Figure 21).[17] The nominal effective exchange rate depreciated in Portugal, Cyprus, and Spain, another comparatively small but positive factor in their favour. Country-specific trends benefited Irish and Portuguese exports, while Greece performed poorly, which could reflect uncertainty from fear of interruptions in the transport infrastructure harming the country's attractiveness as a tourist location. Residual factors that are not explicitly explained in the analysis for Portugal could be the improvements in non-price competitiveness, reported by the OECD, the World Bank, and other institutions.[18]

Overall, the internal devaluation process is very demanding; it requires significant productivity improvements or, if needed, even cuts in income and structural macroeconomic adjustments that go beyond the regular three-year programme period.[19] The euro area programme countries have so far realised marked improvements in their international competitiveness and the analysis suggests this has paid off. The countries should entrench these gains, rather than jeopardise them through slowing reform momentum in the post-programme period.

Programme countries should safeguard gains in competitiveness with continued reforms.

Accelerating non-performing loan resolution

NPLs in the euro area remain a barrier to full recovery and a potential source of instability to the financial system. They represent a problematic issue overall as they tie up bank capital, put pressure on banks' profitability and funding costs, and burden corporates and households with at least some unserviceable debt. As of the end of 2016, euro area banks still held approximately €849 billion of gross NPLs, representing 7.4% of total gross loans, up from 2.6% before the crisis (Figure 22).[20] Although NPLs have declined since 2013 (-11.2%), they remain unevenly spread and uncomfortably high in current programme country Greece and post-programme countries, as well as in Slovenia and Italy.

In recent years, EU and national policy makers designed a series of regulatory and legal policies to accelerate NPL resolution. They encouraged countries and banks to use multi-pronged and complementary approaches. The measures varied. They included enhancing prudential supervision by introducing best practices for lending and provisioning, reforming debt enforcement regimes and insolvency frameworks, developing distressed debt markets by promoting the servicing and sale of NPLs, and introducing flexible and efficient securitisation laws. Certain banks also faced weak corporate governance and a lack of focus on NPL management, and needed to employ various approaches to tackle this particular problem. Solutions included launching internal bank initiatives via joint ventures with other banks and NPL management specialist companies. Establishing such specialised external asset management companies (AMCs), for example, proved particularly effective for countries where NPLs were clustered in a specific sector. Additionally, European institutions incentivised banks to set up internal NPL management units devoted to NPL restructuring and to reducing the formation of early arrears.

EU and national policy makers promoted holistic strategies to encourage NPL resolution.

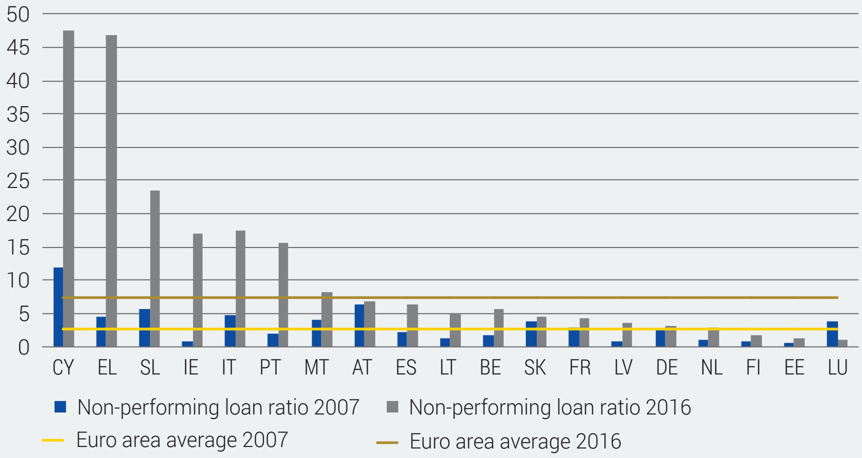
17 The French Treasury concludes that the geographical distribution of exports was an important driver of export market growth in Spain. This effect is partly taken into account in the panel analysis by considering unit labour cost developments relative to trading partners. (See Tresor Economics No. 140 November 2014 "Why are post-crisis Spanish exports so dynamic?", Spanish firms facing a decrease in domestic demand have looked for new export markets and benefited from increased market share in growing countries).

18 See footnote 14.

19 See also the IMF's conclusion in IMF (2015a), Crisis Program Review.

20 The figures and ratios refer to the sample of 117 euro area systemic commercial banks under the supervision of the Single Supervisory Mechanism, which account for about 75% of the euro area banking sector's total assets. The €849 billion of the euro area NPL stock refers to the same sample and source.

Figure 22
Non-performing loan ratio, by country
(% of a country's NPLs to its total loan stock)



Source: ESM calculations based on SNL and Bankscope data

Ireland and Spain have made considerable progress in tackling their NPLs.

All programme countries have attempted to deploy a combination of these solutions but with varying results. Although these measures usually take effect mainly in the medium- and long-term, in Ireland and Spain the stock of NPLs held by the banks has already decreased by 55% and 29%, respectively, from their peak.[21] An early implementation of these measures coupled with a strong economic recovery facilitated NPL restructuring and their reduction through the disposal of NPLs to companies specialised in distressed assets in the secondary market. As the bulk of NPLs in these two countries was mainly concentrated in one sector, real estate, it facilitated the standardisation of strategies and solutions, which sped up the work-out process.

Other former programme countries and Greece still face considerable challenges.

In Cyprus, NPLs have only recently started showing a feeble declining trend as banks' NPL management units and legislative reforms only took effect in 2015. Additionally, NPLs were more granular and spread across all sectors of the economy, making their workout more complex. In Portugal, early crisis management under the Economic and Financial Assistance Programme (2011–2014) focused on fiscal and structural reforms instead of on NPL management, delaying the banking sector's recovery. The fragilities of the banking sector were not properly identified during the programme and, as a result, the necessary reforms targeting NPLs were not carried out during that period. Thus NPLs are still a reason for concern. In Greece, the prolonged recession and political uncertainty made the cleaning of balance sheets more difficult. Greece has seen an increase of its NPL ratio to 46.9% by end of 2016 from 7.4% at the end of 2009. While banks experienced a significant rise in new NPLs in 2016, the rate of increase has, however, slowed materially compared to previous years. This can be attributed to the design and implementation of a comprehensive NPL strategy agreed under the Economic and Financial Assistance Programme. Greece in particular is still suffering more than other countries from weak enforcement and insolvency frameworks. However, NPLs are expected to peak in 2017 as legislative reforms take effect, in line with targets set by the Single Supervisory Mechanism.

[21] December 2013.

Ireland and Spain benefited from introducing external AMCs, which helped to alleviate banks' balance sheets. More specifically, in Ireland and Spain NPLs were predominately concentrated in one sector, real estate. The AMCs could therefore benefit from economies of scale and experienced NPL workout specialists; they improved the liquidity of usually illiquid assets like NPLs by creating a secondary market. Additionally, transferring NPLs to a separate entity forced banks to segment their problem assets, create specialised NPL management units, and emphasise NPL management. These two countries could best benefit from this solution, because both had market access and investment grade credit ratings when their respective AMCs were established, enabling them to guarantee their AMCs, ensure sustainable funding rates, and attract private investors.

Ireland and Spain benefited from AMCs, because their NPLs were predominately concentrated in one sector.

Greek, Cypriot, and to a certain extent Portuguese banks faced a more complex situation and have, therefore, opted for a different solution. High levels of NPLs were spread across all sectors and were coupled with poor collateralisation and/or under-provisioning, thereby disincentivising the transfer of troubled assets to an external AMC. Greek, Cypriot, and Portuguese banks opted, therefore, for on-balance sheet solutions. They continue to work on enhancing their internal NPL workout capacities and improving the overall enforcement and insolvency environment.

With more complex and broadly spread NPL issues, Greek, Cypriot, and Portuguese banks opted for on-balance sheet workout solutions.

Given the complexity of the problem, countries with a large stock of NPLs should pursue a number of mutually reinforcing approaches to resolve their NPLs. Based on recent programme country experiences, country-specific solutions with private sector participation can help NPL resolution. An early implementation of measures helps accelerate the solution. Irrespective of the strategy selected, an enhancement of banks' internal workout capacity is essential to dealing with the remaining legacy issues and mitigating a potential resurgence of the problem in the near future. Legislation to establish a secondary market for NPLs and further improvements to local enforcement and insolvency regimes and frameworks are critical and complementary tools to allow for the efficient resolution of distressed debts. There is currently a broad-based discussion in the European Union on useful initiatives to further strengthen and support the conditions for NPL resolution.

Whatever other solutions are chosen, banks must also improve their internal NPL workout capacity.

PROCESSING THE FINANCIAL TRANSACTIONS OF THE ESM

The ESM is involved in substantial financial operations every day. These are executed by three different departments. Funding and Investor Relations raises the money that the ESM uses to finance its lending operations. Investment and Treasury manages the paid-in capital of €80.4 billion,[22] the money in the reserve fund, and the ESM liquidity buffer. ALM and Lending disburses loans to programme countries.

All the transactions that are carried out as a result of these operations need to be carefully validated and processed. This is the task of the Middle and Back Office division. More specifically, their task is to record, control, process, ensure settlement of, and report on every transaction. The Middle Office embeds risk management and control procedures in its transaction processing. The Back Office ensures that securities and financial instruments are bought or sold for the correct amount of money, at the appropriate time, and with the right counterparty. It also transfers the money.

The Middle and Back Office carries out the following tasks for ESM's funding, investment, and lending operations. In each case, the Middle and Back Office engages in trade validation, trade matching, and in post-trade activities.

Funding and Investor Relations

Once Funding issues a security, the Middle Office validates the trade. The Back Office then takes over and orders a bank to check that the trade details match those of the purchasing institutions. Finally, the Back Office ensures that the trade is correctly delivered.

Investment and Treasury

Once Investment initiates a trade, the Middle Office validates it. This means that the Middle Office closely monitors trading activity, making sure that details are correctly recorded and that investment limits are respected. The Back Office then instructs an outsourced back office provider to settle the trade. The Middle Office and the Back Office each have their separate post-trading activities to make sure trades are correctly executed.

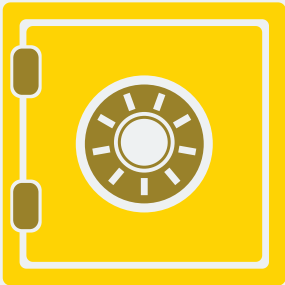
ALM and Lending

The Middle Office participates in the drafting process of lending documents for disbursement. The team verifies that loan details are correctly recorded in the system and provides invoices for all the countries under a financial assistance programme. The Back Office executes disbursements and subsequently monitors inflows and outflows to and from programme countries.

[22] Note that the financial statements in this report refer to the committed paid-in capital of €80.5 billion, the final amount that will be paid in once the two newest ESM Members, Latvia and Lithuania, complete their contributions.

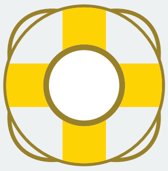
FUNDING

Funding raises the money that the ESM uses to finance its lending operations.



INVESTMENT

Investment manages the paid-in capital of €80.4 billion, the reserve fund, and the ESM liquidity buffer.



LENDING

Lending disburses loans to programme countries.

COORDINATION

The ESM set up a coordination team in 2016 to improve its organisational performance. This small team, which originated in the Middle and Back Office, provides support to change initiatives, such as the implementation of new financial instruments. As the largest and most work-intensive projects in the ESM are related to capital markets, the team is focusing on this area. Concretely, it contributed to projects on the short-term debt relief measures for Greece and on investing in non-euro securities and repurchase agreements. Coordination improves the annual planning and budgeting cycle, oversees the implementation of the outsourcing policy, and performs tasks such as project management.

DANA REIZNIECE-OZOLA
Minister of Finance of the Republic of Latvia, ESM Governor

“The euro significantly contributes to growth as it plays an important role in attracting foreign investment and trade to the eurozone. As well, a single regional currency gives the EU greater weight on the world stage and nowadays unity on the world stage is more important than ever for our security and wellbeing.”

ALM AND LENDING

- ESM continues implementing programme for Greece
- Cyprus successfully exits programme on 31 March 2016
- Spain makes fourth early loan prepayment

ESM continues carrying out Greek programme

Under the agreement with Greece reached in August 2015, the ESM is providing financial assistance of up to €86 billion until August 2018.

In 2016, the ESM continued to implement the Greek programme according to the terms of the loan agreement, or Financial Assistance Facility Agreement.

The ESM made two disbursements to Greece totalling €10.3 billion, all in cash. The funds were used for debt servicing and budget financing (€6.8 billion). The other €3.5 billion was dedicated to net arrears clearance.

The amounts disbursed in cash must be repaid from 2034 to 2059.

Table 1
ESM disbursements to Greece

Tranche	Value date	Final maturity	Amount (billion)
2nd tranche, disbursement 1	21 Jun 2016	23 Jun 2059	€7.5
2nd tranche, disbursement 2	26 Oct 2016	27 Oct 2059	€2.8

Source: ESM

Cyprus successfully concludes programme in March

The three-year Cypriot support programme concluded successfully on 31 March 2016. The programme 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, the ESM's maximum contribution was fixed at €8.97 billion.

In the end, Cyprus only used some 70% of the ESM package. The programme finished without the final disbursement foreseen for January 2016. The ESM disbursed €600 million in 2015 to Cyprus, all in cash, with the final €500 million disbursed on 8 October 2015. The remaining €2.67 billion from the ESM programme envelope was not disbursed and was cancelled. Cyprus also cancelled the IMF programme that was due to end on 14 May 2016 in advance.

The maximum average maturity was set at 15 years. The final weighted average maturity of disbursed loans stands at 14.9 years.

ALM and Lending team shifts focus as crisis fades and only one active programme remains

With the end of crisis, and the successful exit of Cyprus, the ESM has only one active programme. As a result, the work of the team has changed from a primary focus on disbursement to more multi-pronged responsibilities.

In 2016, the ALM and Lending team played an important role, for example, in evaluating the short-term debt relief measures for Greece, which the Eurogroup requested in May and endorsed in December. For more information, see the section explaining short-term debt relief. The team participated in the design of the measures and provided support in the technical discussion with Greece and other Member States. Alongside other divisions, ALM and Lending has also contributed to the implementation of the measures.

Other activities of the ALM and Lending team involved the management of the loan portfolio, with a total outstanding amount of €249 billion at the end of 2016. It also contributed to the preparatory work for the use of new instruments.

Spain makes fourth voluntary prepayment

In November 2016, Spain executed the fourth voluntary early repayment on its bank recapitalisation programme, which had concluded successfully in 2013. This €1 billion voluntary prepayment brings the total outstanding amount of the ESM loan down to €34.72 billion.

Spain had made an initial €1.3 billion prepayment in July 2014, followed by another two totalling €4 billion in 2015.

The maximum average maturity was set at 12.5 years.

How our lending creates budget savings

EFSF/ESM's favourable lending terms generate substantial budgetary savings for programme countries.

The EFSF/ESM has provided loans to Ireland, Greece, Spain, Cyprus, and Portugal at much lower interest rates than those the market would have offered for the amounts they needed. These favourable lending terms generated substantial budgetary savings. As such, they gave authorities additional leeway to implement fiscal and structural reforms to foster growth, or to recapitalise their banking sector, thereby ultimately supporting a country's market access.

The EFSF/ESM estimates these savings in two steps.

We estimate these savings by comparing the effective interest rate payments on EFSF/ESM loans with the interest payments that these countries would have paid had they covered their financing needs in the market. Estimating total budgetary savings requires two steps.

First, we estimate direct savings by comparing the spread between market rates and EFSF/ESM loan costs.

First, we estimate the direct budget savings per disbursement using the spread between the market rates and the actual EFSF/ESM cost. In short, for every disbursement, the EFSF/ESM rate is compared to the 10-year bond yield, used as a proxy long-term market rate, although the actual refinancing would probably be done at a shorter maturity in periods of stress. For our calculations, we apply a cap of 6.4% on market rates. This rate reflects the experience of the European crisis where an elevated yield approaching 7% has suggested significant sovereign stress and imminent loss of market access.[23] This maximum rate of 6.4%, used in the ESM calculations, also ensures consistency among countries.

Then we compute the indirect benefits based on the lower EFSF/ESM refinancing costs.

Second, we calculate the indirect benefits for the programme countries from the favourable EFSF/ESM refinancing costs. In particular, for every annual disbursement, the ESM calculates the gains from the previous year's reduced financing needs, making the same market rate assumptions as for direct budget savings.

[23] The development of market yields preceding the requests for official assistance from Greece (April 2010), Ireland (November 2010), and Portugal (April 2011) support these views. In all three cases, yields rapidly increased once they exceeded these levels. Empirically, the maximum yield at which countries in the euro area have been able to issue over the past eight years has been 6.4%. Therefore, we use this as a relevant benchmark.

As Table 2 shows, budget savings are significant for all programme countries, especially at the peak of the crisis. Greece has benefited the most, with budget savings reaching 5.6% of GDP in 2016 from EFSF and ESM loans and another 0.7% savings from the deferred interest, which will only come due after 2022. For the rest of the programme countries benefits remain, although of lower magnitude, as the countries have secured market access and successfully exited their programmes.

Table 2
Total budget savings
(in % GDP)

Total budget savings (in % GDP)	2011	2012	2013	2014	2015	2016
Ireland	0.1	0.3	0.3	0.3	0.3	0.3
Greece		1.6	4.1	5.0	5.3	6.3
EFSF		1.6	3.7	4.3	4.4	4.8
Deferred interest			0.4	0.7	0.7	0.7
ESM					0.2	0.8
Spain		0.0	0.2	0.2	0.2	0.2
Cyprus			0.1	0.2	1.9	2.1
Portugal	0.1	0.4	0.6	0.7	0.7	0.7

Source: ESM calculations based on European Central Bank data

VILIUS ŠAPOKA
Minister of Finance of the Republic of Lithuania, ESM Governor

“The single currency in 19 Member States offers huge benefits for everyone, i.e. from a state to a citizen, from a big company to small business. It removes barriers among countries and creates better conditions for trade and export and, hence contributes to stronger GDP growth and helps ensure economic stability.”

FUNDING AND INVESTOR RELATIONS

- EFSF/ESM raise €695 million in 2016 in new German Namensschuldverschreibungen programme
- Long-term issuance for the year focuses on long and ultra-long maturities
- ESM successfully issues almost €35 billion in bills, all at negative rates

The continuing negative yield environment, macroeconomic developments, and election results all affected markets in 2016. The ESM Funding and Investor Relations team adapted its issuance strategy, tailoring it to address these issues and to both better target and expand its investor base. The launch of the N-bond (Namensschuldverschreibungen) private placement programme in January was also part of the strategy to diversify the investor base and provide an additional opportunity for long-end investors. As a consequence of the flexible funding strategy and focused investor relations work, all issuances were well subscribed and the ESM successfully completed its funding target for the year by early November.

ESM's long-term funding target declines over the year

In December 2015, the long-term funding target for combined EFSF/ESM 2016 bond issuance was announced to be €42.5 billion: €28.5 billion for the ESM and €14 billion for the EFSF. The end of the Cypriot programme and another Spanish early repayment, however, lowered those amounts.

In March, the target for ESM bond issuances was reduced by €3 billion to €25.5 billion. Most of this amount represented funds that Cyprus did not use at the closure of its programme in March. A small part stemmed from proceeds on N-bond sales.

The fourth Spanish prepayment in November reduced the long-term funding target by another €1 billion. The ESM therefore finished the year by raising €24.6 billion (including N-bonds) with bond issuances.

ESM successfully issues long and ultra-long maturities

Throughout 2016, the ESM issued bonds across the yield curve ranging from the tap of a 5-year bond to the tap of a 40-year bond. There was, however, a particular focus on long-end and ultra-long-end issuance. Two factors drove this development. First, the programme for Greece, announced in August 2015, meant that the ESM could subsequently issue much longer maturities. The ESM used this opportunity to complete its yield curve at the long end in line with the maturities of its loans and up to a hard limit of 45 years. Second, investor appetite for long-end bonds grew. The negative yield environment at the shorter end of the curve prompted many investors to invest in longer maturities, moving further out the yield curve than would normally be expected. The ESM listened carefully to investor demand and responded with issues of very specific, non-standard maturities, such as the 16-year bond issued in May raising €3 billion; and the 26-year bond issued in July raising €2.5 billion.

Conscious of the market discussion around the lack of liquidity in secondary markets, the ESM addressed the issue by extensively tapping existing bonds. Reopening existing bonds is a good means of increasing their size and providing additional liquidity for bondholders. It also allows investors to buy bonds that they were not able to at the initial launch. The use of taps is an integral part of the ESM's funding strategy because it provides investors with a regular presence in the markets across the yield curve, which is the same approach sovereigns use.

The ESM can tap bonds via syndication and by auction. The ESM made particular use of the auction process in 2016 with four taps issued via auction. Auctions, typically used by government issuers, are not only an effective means of increasing liquidity, but they also reinforce the view of the ESM as a benchmark, government-style issuer. The ESM is the only supranational issuer that uses the auction process. The German central bank, the Bundesbank, operates the ESM's auction system.

To ensure satisfactory secondary market liquidity for investors, the data analytics team has created tools to monitor liquidity in ESM and EFSF bonds (Figures 23 and 24). Overall, the ECB's quantitative easing programme has not significantly reduced ESM bond turnover. Quarterly turnover is around €30 billion and trade sizes remain good.

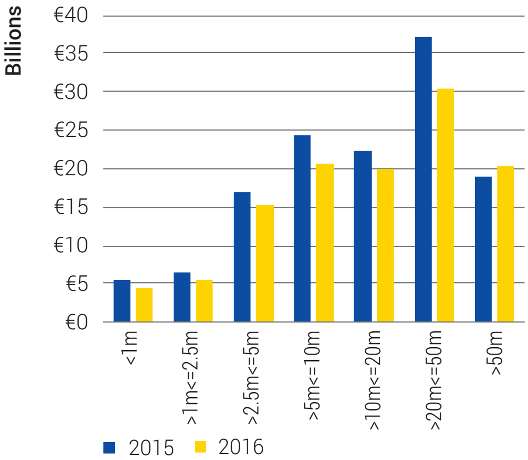
ESM raises almost €35 billion in bill programme despite negative rates

The ESM also continued its regular short-term funding programme, with 23 issues of 3- and 6-month bills in 2016. It raised almost €35 billion through the bill programme over the year, a particularly impressive amount given that all bills were issued at negative rates. The rates fell as low as -0.6984% for a 3-month bill issued in December. Despite the negative rates offered, ESM bills were consistently well subscribed.

ESM introduces N-bond private placements

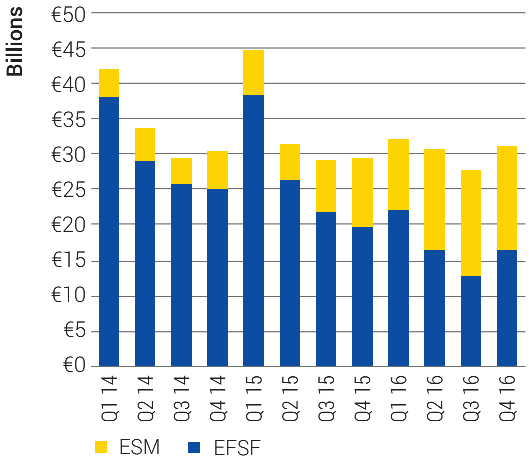
In January 2016, the ESM introduced N-bonds, registered bonds under German law issued in private placement. This funding instrument offers a new investment possibility for mainly long-term investors. It therefore improves the structure of the debt

Figure 23
ESM and EFSF bond turnover volume
(by trade size bracket)



Note: Figure covers EFSF and ESM bonds excluding public-sector purchase programme.
Source: ESM

Figure 24
ESM and EFSF quarterly turnover volume



Note: Figure covers EFSF and ESM bonds excluding public-sector purchase programme.
Source: ESM

portfolio and is aligned with the ESM's strategy to further diversify the ESM's funding instruments and widen its potential investor base. There is no fixed target for N-bond issuance. Whilst they are issued according to investor inquiries, the ESM Investor Relations team actively marketed the N-bond to German long-end investors. By the end of the year, the EFSF and ESM combined had raised a total of €695 million in N-bonds.

EFSF/ESM 2017 funding targets shift after Greek debt relief measures

On 5 December 2016, the Eurogroup approved the ESM's short-term debt relief measures for Greece. One of the short-term measures is the execution of the floating rate note exchange. Under this measure, floating rate notes previously disbursed are exchanged for new long-term fixed-rate bonds. This measure will benefit Greece as it will reduce its interest rate risk. After some time, the fixed-rate bonds which are on the books of the Greek banks are bought back versus cash and can be cancelled again.

This operation therefore will need to be funded and as a consequence, the EFSF and ESM announced they would raise in 2017 a combined €57 billion: the EFSF, €40 billion; the ESM, €17 billion. Compared to previous announcements, this amounts to a total increase of €7 billion.

The EFSF funding volumes subsequently rose by €13 billion to execute this short-term measure for Greece. This €13 billion is to cover the expected liquidity needs following the exchange of the floating rate notes disbursed for bank recapitalisation purposes.

To keep the overall increase of funding amounts limited, the annual funding amount for the ESM was reduced by €6 billion even though additional funding was also required for the exchange of the floating rate notes issued under the ESM. This was possible by reducing the liquidity buffer and due to the flexibility from which the ESM benefits through its bill programme which allows it to raise short-term money if needed.

EFSF/ESM target broader investor base with new instruments, prepare US dollar issuances

Both entities will continue their N-bond programme in 2017 and will include the amounts raised in the overall long-term funding. The EFSF and ESM will continue to issue on all parts of the curve and identify pockets of investor demand. As part of the strategy to diversify its investor base and to respond to the maximum investor demand, the ESM will begin to issue in currencies other than the euro. The ESM is preparing a US dollar bond programme.

The introduction of the N-bond programme in 2016 and the scheduled launch of the US dollar bond programme in 2017 adhere to the ongoing strategy of increasing the spectrum of EFSF/ESM funding instruments to widen its potential investor base. It is part of the ESM's mandate to raise capital in the financial markets to support programme countries. The ESM must therefore always be able to raise large volumes at short notice. More funding instruments and more potential investors will assist the ESM in achieving this objective.

Emerging financial technology brings ESM challenges and opportunities

Financial technology (fintech) companies, or "companies that use technology to make financial systems more efficient"[24] may well revolutionise the way the financial industry operates. The ESM stands ready to ensure it avoids the threats and seizes the opportunities that this dynamic emerging field presents.

Financial technology could revamp how the financial industry – and the ESM – do business.

As an IFI that issues billions of euros to fund loans for its programme countries and invests its €80.4 billion in paid-in capital,[25] the ESM needs to stay abreast of new innovations in financial technology, which are intended to simplify operations and reduce costs. Additionally, electronic systems that connect issuers to investors directly could further simplify the bond transaction process. Fintech could thus have far-reaching consequences for many ESM departments, including Middle and Back Office, Funding and Investor Relations, Investment and Treasury, Finance and Control, and IT and Operations.

Innovative technology could, for example, allow the ESM to better navigate markets, deliver better value for shareholders, and better meet investor needs.

The ESM is actively pursuing the use of fintech in-house, focusing on data analytics. Concretely, the ESM is developing cutting-edge tools to analyse market data and investor patterns. With its unique mandate, the ESM has a particular need to identify and understand the fundamental changes, trends, and evolving mechanics that influence European capital markets. Hence, the ESM is building a sophisticated data warehouse and pioneering technically advanced data analysis methods to provide market intelligence for our funding operations.

ESM is already building its own fintech tools to analyse market data and investor patterns.

One example is the ESM's use of financial networks to help visualise how political or economic events affect market sentiment. Figures 25 and 26 illustrate the relationships between different sovereign bond markets. They also forewarn about the impact of political or economic change on market stability.

By studying financial networks, the ESM can see how events may affect market sentiment.

[24] Wharton School of the University of Pennsylvania, Wharton FinTech Club, February 2016.
[25] Note that the financial statements refer to the committed paid-in capital of €80.5 billion, the final amount that will be paid in once the two most recent ESM Members, Latvia and Lithuania, complete their contributions.

The deeper the blue, the stronger the dominating correlation between countries.

Bond yield correlation network figures 25 and 26 show the dominating positive correlations (blue) and negative correlations (red) between sovereigns on a given day. When viewed as time-lapse videos, they can also visually demonstrate the strong to weak correlation over a given period of time.

The week before the Brexit referendum

The uncertainty around the outcome of the UK referendum led to a dominant trend of negative correlation, with bond movements diverging, as investors sought safe haven Germany rather than peripheral countries.

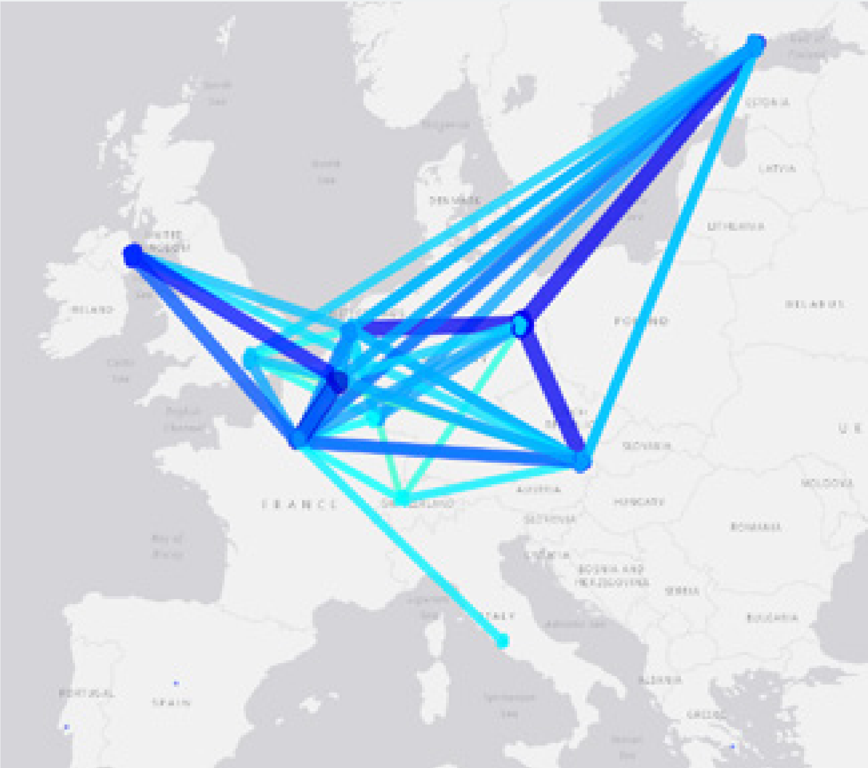
Figure 25

Note: For further information, please refer to ESM Working Paper No 8: European Government Bond Dynamics and Stability Policies Taming Contagion Risks.
Source: ESM, screenshots provided by Firamis (www.firamis.de)

The week after the Brexit referendum

Following the outcome of the UK referendum, market sentiment recovered and European sovereign bonds converged, moving more in tandem again.

Figure 26



Note: For further information, please refer to ESM Working Paper No 8: European Government Bond Dynamics and Stability Policies Taming Contagion Risks.
Source: ESM, screenshots provided by by Firamis (www.firamis.de)

To share the institution's experiences, ESM representatives have spoken at a number of forums, for example in London and Washington D.C., on 'How we can be leaders in fintech'. The ESM is also an active member of several fintech circles, which enables the institution to stay on top of new technological developments and any potential challenges.

The ESM takes part in fintech forums, sharing its experiences, and learning from others.

The ESM also actively promotes fintech through collaboration and dialogue with other IFIs. As a relatively new institution, the ESM is largely unencumbered by historical systems and ways of working and can create and implement innovative ideas relatively easily. The ESM is looking for opportunities to improve efficiency and is thus monitoring the fintech community for any solutions that could enhance its work environment.

The ESM is actively promoting and evaluating new fintech tools to improve its efficiency.

Major rating agencies affirm ESM's high rating position

Table 3
ESM ratings

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 trend
AAA	F1+	Stable	Aa1	P-1	Stable	AAA	R-1 (high)	Stable

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

PIERRE GRAMEGNA
Minister of Finance of the Grand Duchy of Luxembourg, ESM Governor

"The euro has been a true success story and its benefits are felt on a daily basis by citizens and businesses throughout Europe. But the euro is more than just a currency, it is a peace project that has brought stability and unity to its Member States."

Issuer strategies in European sovereign and SSA markets

Negative rates force investors, European sovereign and SSA issuers to alter strategies

The European sovereign debt crisis, regulatory and technological change, and central banks' large-scale and unconventional monetary policies have significantly reshaped financial market conditions over the last few years. Amid such sizeable change, disentangling the marginal impact of any single factor constitutes an extraordinary challenge. Yet, it is fair to say that, while some of these changes triggered the foreseeable or intended market reaction, in other cases the interaction of a number of factors led markets to uncharted territory. They also required European sovereign and supranational, sub-sovereign and agency (SSA) bond market participants to reconsider their strategies.

The crisis, regulatory change, and unconventional monetary policy have altered euro area debt market conditions.

When the ECB announced, for example, its PSPP in January 2015, it soon became evident that such a large buyer was going to put significant downward pressure on European sovereign yields and spreads, and considerably flatten yield curves. Indeed, as a reference, the German 10-year sovereign bond, which yielded 0.52% the day before the PSPP announcement, reached an historical low of - 0.19% in July 2016. Similarly, the 10-year spread relative to Germany dropped on average by about 50 basis points in Italy and Ireland, 30 basis points in Spain, and 60 basis points in Portugal between 2014 and 2015. As a consequence, in their hunt for yield, investors rethought their investment strategies, shifting across asset classes or moving further out along the yield curve.

The ECB's PSPP, for example, depressed yields and spreads, and helped flatten yield curves in 2015 and 2016.

At the same time, PSPP may have weighed on market liquidity.[26] Indeed, the large and credible PSPP market intervention persuaded investors not to challenge the ECB, leading to one-sided trades with a corresponding drop in flows and liquidity. While the PSPP may have aggravated these dynamics, they had started before the PSPP, driven by factors such as regulatory changes limiting primary dealers' room to manoeuvre, and the shifts on the buy-side towards bigger and more concentrated asset managers.

The PSPP may also have contributed to tighter liquidity.

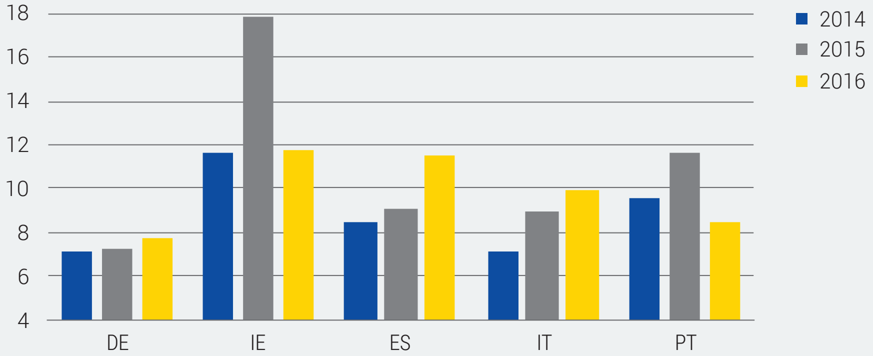
European issuers modified their strategies to benefit from the new environment. On the positive side, they were able, until very recently, to extend the average maturity of their issuances and to reduce their costs significantly (Figures 27 and 28).[27]

The changes meant issuers could extend the average maturity of their issuances and cut costs.

[26] In the press conference that followed the ECB meeting in December 2016, ECB President Mario Draghi said: "We are aware that our purchase programme has contributed, among other relevant factors, to increase the repo rates used to obtain collateral of the best credit quality". As a result, the ECB decided to accept cash as collateral in its PSPP securities lending to support "the euro area repo market liquidity and functioning".

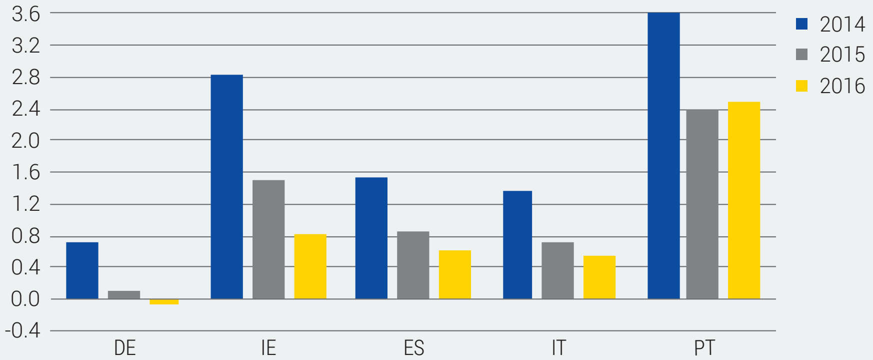
[27] Due to various country-specific factors, Portugal constitutes an exception to this pattern between 2015 and 2016. The high-weighted average maturity at issuance in Ireland in 2015 should be considered an exceptional point, distorted by a significant issuance of 30-year bonds.

Figure 27
Weighted average maturity at issuance
(in years)



Source: ESM calculations based on national treasuries' data

Figure 28
Cost of issuance
(in %)



Source: ESM calculations based on national treasuries' data

Demand for high-quality assets remains high.

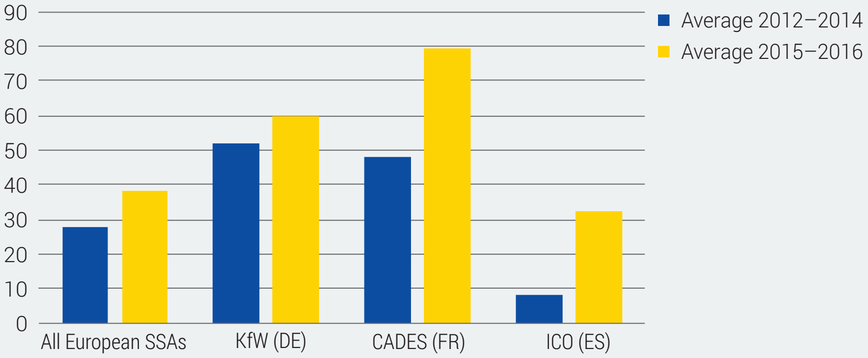
In doing so, they took advantage of the persistently low-yield environment with flattening curves which resulted from, principally, the sizeable ECB purchases in relation to net issuance, the long-term bond buying of investors 'riding-the-yield curve', and the regulatory changes favouring demand for relatively safe and liquid assets. In particular, under Basel III's liquidity coverage ratio, banks needed to dramatically increase their holdings in high-quality assets such as sovereign and supranational bonds. Whilst most banks had already complied with ratio requirements, the rollover of maturing bonds and fresh capital meant that banks' treasuries maintained their healthy appetite in 2016. Meanwhile, the Solvency II Directive also fueled the insurance sector's demand for high-quality assets.

Nonetheless, issuers have needed to diversify their client base and add liquidity to their bonds to cope with high financing needs and limited market liquidity.

But issuers also face challenges. On the negative side, European issuers, with very high GFN,[28] have needed to cope with a scenario where overall market liquidity has declined and the gap between liquid and illiquid assets has widened. To do so, issuers have devoted considerable effort over the last few years to diversifying their client base and to strengthening the liquidity of their assets.

[28] As a reference, gross bond issuance will amount to about €720 billion in the four biggest euro area sovereign bond markets in 2017, which is €6 billion more than in 2016.

Figure 29
Issuance in USD
(% of total issuance)

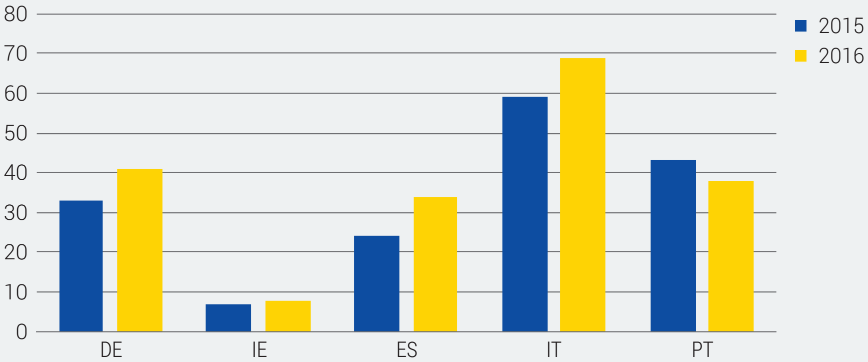


Source: ESM calculations based on Bloomberg data

To diversify, European sovereign and SSA issuers have increasingly looked into less standard instruments. These include inflation-linked bonds, green bonds, and non-euro-denominated bonds. The preference for dollar versus euro issuance has been particularly marked in the European supranational sector lately (Figure 29). In terms of liquidity, given that most trading on any given bond typically happens around auction days, European issuers have tilted towards a more frequent market presence at the expense of tapping smaller amounts on average (Figures 30 and 31).

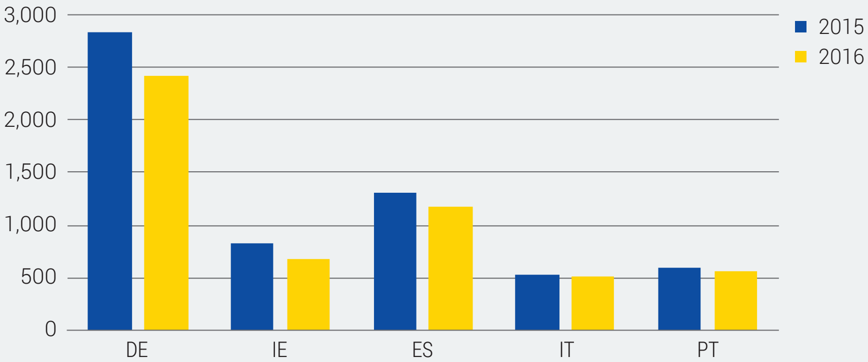
To do so, they have made use of less standard instruments and tapped smaller amounts more frequently.

Figure 30
Number of taps



Source: ESM calculations based on Bloomberg and national treasuries' data

Figure 31
Average amount issued per tap
(in € million)



Source: ESM calculations based on Bloomberg and national treasuries' data

At the end of 2016, market sentiment shifted, favouring accelerating growth and reflation.

A large market repricing is the main challenge looking forward. In the last quarter of 2016, in response to a number of factors,[29] investors seemed to start pricing in a new macroeconomic and market scenario. In particular, market sentiment began to move away from a secular-stagnation view towards an alternative one where global growth could potentially accelerate, a reflationary process may emerge, and the persistently supportive monetary policy could gradually come to an end.

As a result, the sovereign bond curve steepened, and investor attention swapped to equity markets.

Naturally, this shift in investors' central scenario altered markets, which saw increases in bond yields, steepening yield curves, and an overall rotation to equity from fixed income. Amid this bond price sell-off, peripheral bond spreads against Germany have also widened considerably since late September 2016.

It is yet unclear whether this new investor view will hold sway for long and how issuers will respond.

Looking ahead, it remains to be seen how the forthcoming economic figures and political developments may lead markets to accelerate or to undo the recent repricing trends, and how European issuers will react to a tougher scenario for bonds. In this regard, despite the increases just mentioned, global bond yields could still rise sharply from current levels if expectations of a reflationary scenario strengthen. This could lead to significant market turmoil especially taking into account how much key market players are exposed to interest rate risk.

When the ECB scales back its purchase programmes, however, there is a risk of substantial widening of peripheral spreads.

The ECB's asset purchase programmes led to a significant reduction in peripheral spreads, even taking into account other standard determinants of credit risk. When these programmes are scaled back, the risk could be that peripheral spreads see a non-negligible widening again. This would raise countries' financing costs again and might therefore require additional adjustments in fiscal policy.

[29] These include: the increased momentum in global economic activity; the acceleration in headline inflation figures; the outcome of the US presidential election and the announcement of more fiscal stimulus for the US economy and expectations of a more aggressive tightening in US monetary policy than previously anticipated.

INVESTMENT AND TREASURY

- ESM realises gains of €360 million in paid-in capital portfolios
- ESM revises Investment Guidelines

ESM realises gains in 2016

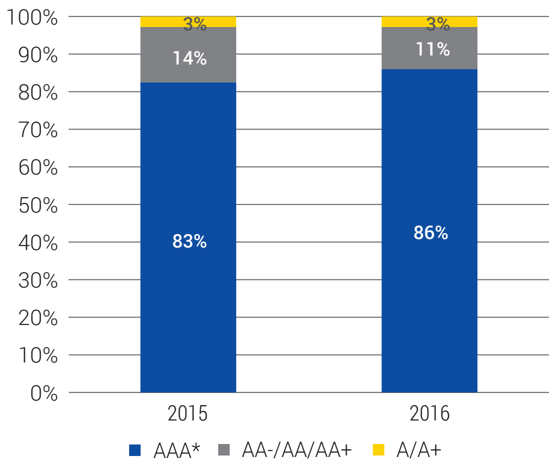
In 2016, the value of the ESM's capital increased, albeit more slowly than in previous years given the low yield environment in Europe. The ESM manages, prudently, the €80.4 billion of paid-in capital[30] that underpins the institution's creditworthiness and is essential to supporting the ESM's capacity to borrow on financial markets at favourable rates.

The ESM portfolios delivered a positive performance during the year despite the negative yield environment, realising a €360 million gain in accounting terms. The continued decline in European bond yields, in particular at the front end of the yield curve, pushed the price of fixed-income assets higher. German 2-year yields fell to a record -0.77%, well below the 0.40% ECB policy rate on the deposit facility, and the 5-year yield below -0.50%, reflecting the central bank's continued effort to conduct an accommodative monetary policy. The resulting appreciation in bond prices more than offset the impact of the negative running yield on the portfolio and generated the year's positive performance. Including €360 million in income in 2016, the realised gain of the paid-in capital since inception increased to almost €1.3 billion, which will help the ESM achieve its goal of long-term capital preservation in an environment of negative interest rates.

The ESM continued to maintain a prudent approach in the management of the interest rate risk of the paid-in capital portfolio. As yields in the euro area fell deeper into negative territory during the first half of 2016, the ESM gradually reduced the interest rate sensitivity of the paid-in capital portfolio. In late 2016, the ESM was able to adjust the portfolio interest rate risk, by increasing exposure to the 5-to-10-year segment of the yield curve, following the upward correction in bond yields. This fine-tuning took place particularly after the US presidential elections when market participants started to anticipate a change in economic policies that could spur growth and inflation.

The ESM also chose to keep its overall credit exposure relatively stable. As a result, the breakdown of the credit quality by rating remained unchanged, compared to the previous year. In particular, the share of securities rated AA-/Aa3 and above has remained at 97% (Figure 32).

Figure 32
Rating distribution of the paid-in capital
(by lowest rating, including cash held with the Eurosystem)

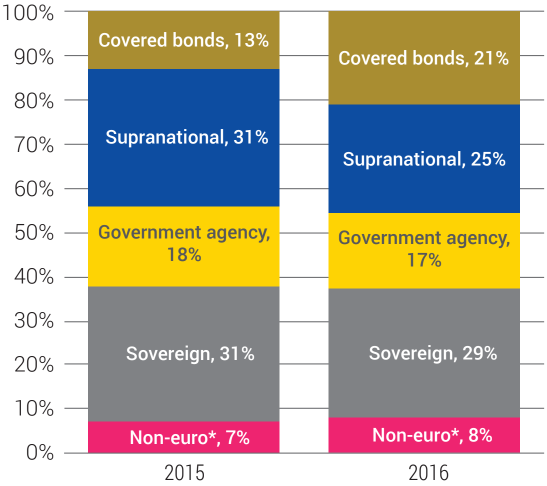


Note: *Including cash held with the Eurosystem
Source: ESM

The ESM steadily expanded its list of eligible issuers in the covered bond and sub-sovereign space, targeting assets with higher returns that are not included in the ECB asset purchase programme. The ESM also slightly increased the portfolios' share of non-euro short-term securities, hedged against foreign currency risk, and of highly rated euro-denominated covered bonds issued primarily by non-euro area entities. Consequently, the overall weight of supranational institutions, while still important, declined modestly (Figure 33).

[30] Note that the financial statements refer to the committed paid-in capital of €80.5 billion, the final amount that will be paid in once the two newest ESM Members, Latvia and Lithuania, complete their contributions.

Figure 33
Securities breakdown of ESM paid-in capital
(by asset class, excluding cash held with the Eurosystem)



Note: *Non-euro denominated assets.
Source: ESM

ESM revises Investment Guidelines

In 2016, the ESM continued its effort to improve the framework for its investment policy, thoroughly revamping its Investment Guidelines. In 2015, the ESM had already increased the range of eligible issuers. The ESM undertook the 2016 revision for three reasons: to improve the technical investment framework, to adjust the Guidelines to the expansion of the ESM's investment capacity, and to strengthen the ability to preserve capital in an environment of protracted and deeply negative bond yields.

As part of the improvement of the framework, the revised guidelines introduce some clarifications regarding the return objective of the paid-in capital. While the priority of the investment portfolios remains to ensure liquidity, the availability of the ESM's maximum lending volume, and the ESM's creditworthiness, the Investment Guidelines require that it should also provide a return in line with a "benchmark portfolio constructed with similar objectives and constraints". This objective complements the already existing target of long-term capital preservation.

One of the key objectives of the revisions is to enable the ESM to continue expanding its operations and its capacity to manage its assets effectively. To implement derivative instruments such as interest rate swaps and cross-currency swaps, both essential to managing risk, the Investment Guidelines now enable the ESM to use some of its assets as collateral. This will contribute to developing the ESM's capacity to diversify its assets outside the euro area, and, in some cases, to increase the return on its assets.

In addition, the newly revised Investment Guidelines allow the ESM to contract repurchase agreements (repos). This instrument, which is widely used among central banks and public institutions, is essential to access liquidity. In particular, repos help disconnect liquidity needs from asset sales in exceptional situations and reduce the cost of liquidity. This instrument could also contribute to mitigating the cost of negative interest rates, when used as part of a relative value strategy.

Finally, while keeping the overall credit quality of the investment portfolios at a high level, the revisions expanded the investment universe. To do so, the ESM adjusted the credit rating eligibility criteria

to AA- from AA applied to the General Eligible Asset List, in which €75 billion of the paid-in capital must be invested. This revision brings various benefits: first, it improves the ESM's ability to respect capital preservation by increasing the average portfolio yield; second, it contributes to reducing the ESM's country concentration risk.

Investment strategy process

INVESTMENT STRATEGY

PRESERVES CAPITAL + REGULARLY ADJUSTS PORTFOLIO STRUCTURE > Long-term strategy regularly reviewed to ensure smooth adjustment over time

ASSET ALLOCATION

DIVERSIFIES ASSETS + FOCUSES ON ASSETS WITH AMPLE LIQUIDITY > ESM diversifies its investments to ensure only modest impact on any single issuer or security

MARKET IMPLEMENTATION

CALIBRATES TRANSACTIONS TO REFLECT MARKET DEPTH + CONDUCTS TRANSACTIONS ACROSS VARIOUS CHANNELS > ESM adjusts transaction size and trades with a diversified group of eligible international counterparties

EDWARD SCICLUNA
Minister of Finance of Malta,
ESM Governor

“I believe that a single currency is an important complement to the Single European Market, which would make the European Union a more powerful player in the global economy. Since the economic and financial crisis, many important steps have been taken to make the euro function more effectively, such as the creation of the ESM. The ESM and its precursor the EFSF have translated the European spirit of solidarity into effective financial and economic assistance to euro area Member States in time of need.”

RISK AND COMPLIANCE

- Risk and Compliance supported a prudent revision of the ESM's risk framework, including the investment universe in 2016, as part of its role in continually adapting risk management and compliance to evolving business requirements and market conditions within the given risk appetite;

- Risk and Compliance hosts internal seminars and brings in external risk experts, helping further embed the ESM's three lines of defence model.

Risk and Compliance at the ESM is built on a best practice framework, with all policies regularly reviewed and continuously adjusted to new operational needs within the given risk appetite. In 2016, Risk and Compliance contributed to the ESM's work on short-term debt relief measures for Greece and the prudent revision of the ESM's Investment Guidelines in the context of the low interest rate environment.

During the year, the Risk and Compliance team developed appropriate risk methodologies to manage the risks on new debt instruments and capital investment, including in foreign currency. Specifically, it defined the potential risks arising from foreign currency swaps and forwards, interest rate swaps, and cross-currency swaps, supported the establishment of collateral management operations, and reviewed the risk policies for those purposes.

The ESM Risk and Compliance team also continues to develop the risk culture throughout the institution. In 2016, it brought in a number of speakers and held seminars with all internal teams to reinforce the importance of each staff member's role in risk management under the three lines of defence model, and to provide training on operational risk and fraud prevention.

In addition, for the first time, the ESM participated in the 12th Central Banks Risk Management Conference, which was organised by the Bank for International Settlements. The ESM Risk and Compliance team continues its close collaboration with risk experts in other IFIs to exchange best practices, and regularly participates in the IFI Operational Risk Forum and its European Chapter.

ESM adheres to strict risk management framework

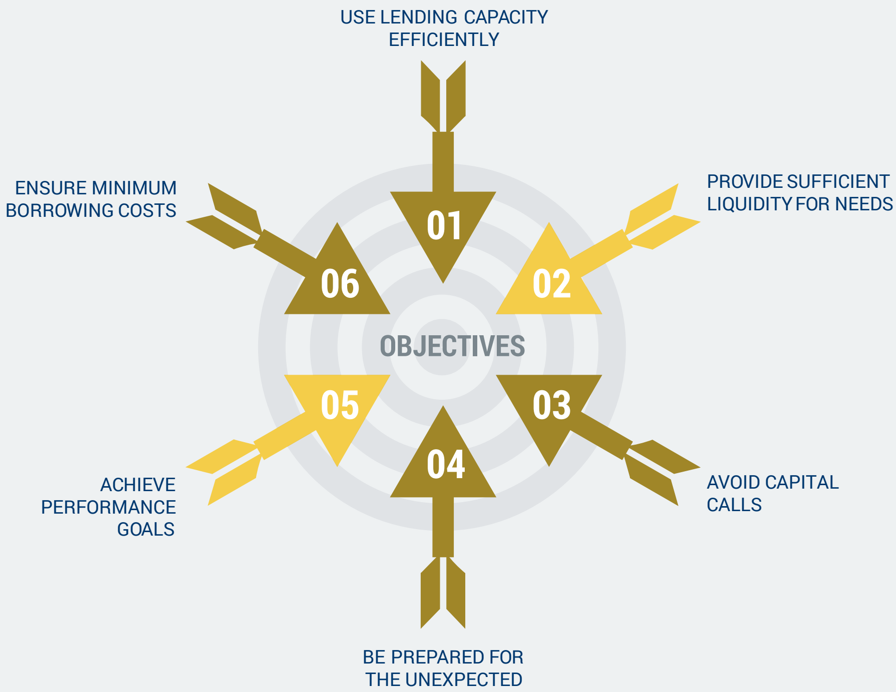
The ESM's approach to risk management derives from the ESM Treaty and the High Level Principles for Risk Management, which in summary are to:

- adopt 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.

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 a dedicated Board Risk Committee, which advises on current and future risk appetite and assists in reviewing and overseeing the ESM's risk management framework. In addition, the ESM has an Internal Risk Committee, which evaluates and monitors the implementation of the ESM's risk management framework.

Risk appetite

The ESM Board of Directors decides on the appetite for risk that the ESM is willing to accept in the execution of its mandate. The ESM Risk Policy documents this risk appetite.

Risk culture

The strong risk culture at the ESM is founded on a risk function that acts as an independent division of the institution reporting directly to the Managing Director. This in turn ensures rigorous standards and objectivity in decision-making, in a context of shared awareness of risk matters across the institution.

ESM key risks

The ESM is subject to a number of financial and non-financial risks. These risks are a function of the ESM's mandate and operational activities.

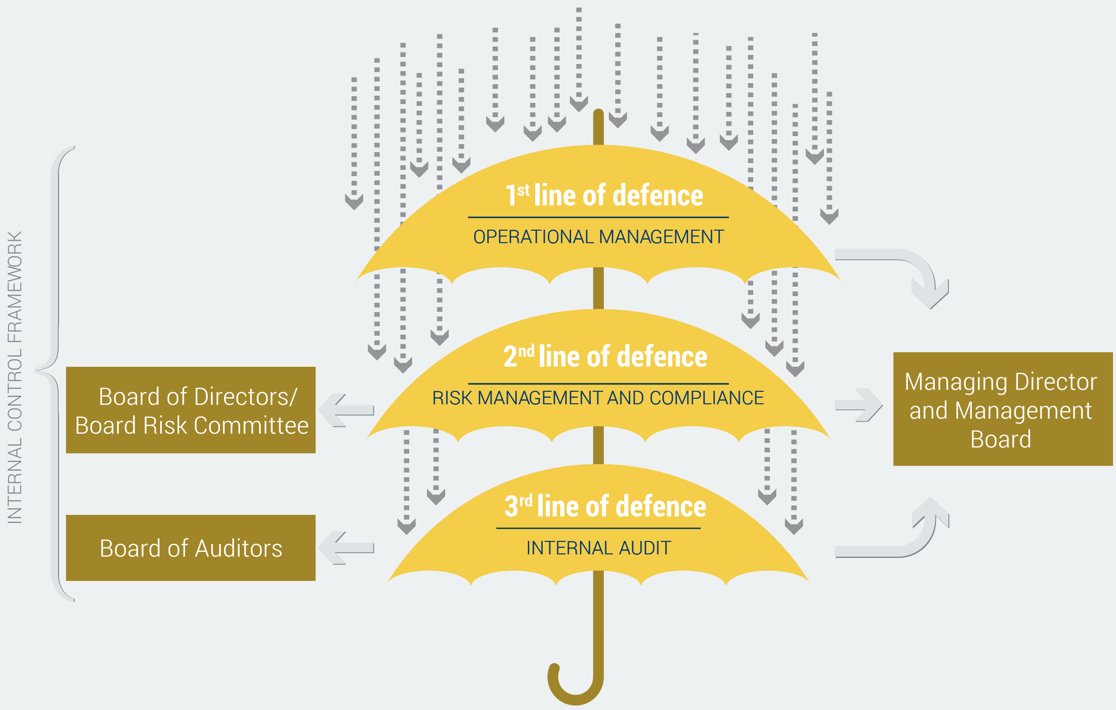
The major financial risks that the ESM faces are:

Credit risk – the risk of loss arising from the inability of a counterparty to fulfil its contractual obligations. The ESM is exposed to credit risk from three main sources: stability support activities, investments on highly rated securities and counterparty risk related to its investment, funding, and risk hedging operations.

Market risk – the risk of loss arising from changes in the values of financial assets and liabilities (including off-balance sheet items) due to market fluctuations.

Liquidity risk – the ESM faces two main types of liquidity risk: funding liquidity risk and market liquidity risk. Funding liquidity risk relates to the potential for loss or excessive costs in securing necessary funding on a timely basis. Market liquidity risk is the risk of loss arising from an investment that cannot easily be liquidated without a large negative impact on market prices.

The three lines of defence model



The ESM follows the 'three Lines of defence' governance model, which sets out clearly drawn lines of authority and appropriate segregation of powers and duties for risk management. 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 management and compliance function, led by the Chief Risk Officer, which oversees the risks assumed by the business and ensures they are appropriately managed and monitored. 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, as well as to, respectively, the Board Risk Committee and the Board of Auditors, to ensure their independence.

The financial risks are described in more detail in the notes to the financial statements. The main non-financial risks the ESM faces are:

Operational risk – the risk of 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. The ESM operational risk management policy stipulates no tolerance for material operational risks.

Reputational risk – the risk of loss and/or damage resulting from a deterioration in the ESM's reputation, reducing its market access, inability to attract staff, and other similar consequences. The ESM manages this risk by undertaking its mandate with the highest professional standards and by having centralised coordination of external communication.

Legal risk – the risk of loss and/or damage resulting from inadequate or inefficient documentation; litigation against the ESM or its assets; and non-compliance with the ESM Treaty, or any other applicable laws and contractual obligations. Legal risk is managed with the guidance of internal and external legal counsel.

Compliance risk – the risk of loss and/or damage associated with non-compliance with internal policies, procedures, guidelines and any external regulations, which might govern the ESM. The ESM Code of Conduct defines the fundamental ethical principles to which ESM staff must adhere, such as the requirements regarding the employee's integrity, handling conflicts of interest, and information protection.

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 (operational, reputational, legal, compliance, and political risk).

Top ESM risks in 2016

FINANCIAL AND OPERATIONAL RISKS

Investment losses | BMS* Credit stress | Cyber attack | Reputational risk

POTENTIAL RISKS TO OUR MANDATE/MITIGATION

Financial capacity
- Robust balance sheet
- Capital strength
- Prudent investment and risk management
- AAA/AA+ rating

Operational capacity
- Professional experienced staff
- Flexible, efficient systems
- Robust, effective procedures

Reputation
- Credibility
- Prudence
- Excellence
- Integrity

MAIN GLOBAL RISKS

Negative/low and rising interest rates | Political risk | Cyber and data security risk | Fraud and conduct risk

Note: *BMS – beneficiary Member State.
Source: ESM

Risk of investment losses. In 2016, low and negative interest rates meant that the high-quality liquid assets in which the ESM invests yielded a low and, in a few cases, negative return. Looking ahead, more investment assets could be subject to negative returns. Also, should interest rates rise, investments would incur mark-to-market losses. But, over the medium- to long-term, higher interest rates increase investment returns and strengthen the ESM's capital position.

Mitigants: In 2016, the ESM sold assets to realise profits. Retained earnings can also provide a buffer for paid-in capital against future financial losses. The ESM continues to apply prudent investment and risk management policies.

Beneficiary Member States' credit stress. An inherent, non-discretionary risk for the ESM is repayment risk on the loans it provides to beneficiary Member States. The ESM passes on the benefits of its favourable interest rates to those countries through low interest rates on loans. An increase in global interest rates, however, could place credit stresses on beneficiary Member States and increase loan repayment risk. Political uncertainty could exacerbate this risk.

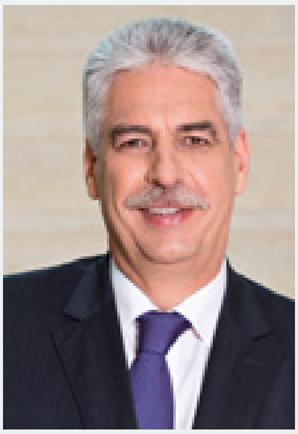
Mitigants: the ESM employs a diversified funding strategy to lock in access to low funding costs. It seeks to ease the repayment burden for its programme countries by passing on these low funding costs and by setting loan repayments out further than other international institutions. The ESM also has an early warning system to detect repayment risks and facilitate prompt corrective action.

Cyber attack or information and system security risk. The ESM must protect the information it holds, a large majority of which is confidential and sometimes market sensitive. And as an IFI, the ESM makes use of global systems that are facing ever more cyberattacks. The confidentiality of data and operational integrity of systems is core to the successful execution of the ESM's mandate.

Mitigants: the ESM aims for advanced cybersecurity measures. It has established an information security policy, and an information and communications technology security policy, and conducts regular penetration testing of ESM's systems, phishing exercises, and on-going staff training.

Reputational risk. The risk of fraud and mismanagement of ESM investments is of prime concern to the ESM. Should they occur, these risks would adversely impact ESM's reputation and operational integrity, which are core to the effective delivery of its financial stability mandate.

Mitigants: the ESM undertakes an annual fraud risk assessment and maintains a fraud risk management programme. It has established a robust internal control framework, a Code of Conduct, information barriers policy, and reputational risk guidelines.



HANS JÖRG SCHELLING

Minister of Finance of the Republic of Austria, ESM Governor

“The euro does not only give the citizens the freedom to compare and purchase goods and services all over Europe, it also provides entrepreneurs and businesses with the unique opportunity to access one of the largest markets in the world without any exchange rate risks. For a small open and globally oriented economy like Austria, I have no doubt that the euro will remain an anchor of stability in a world that has become more uncertain.”

TRANSPARENCY AND ACCOUNTABILITY

As an institution with a public mandate, transparency and accountability are essential for the ESM.

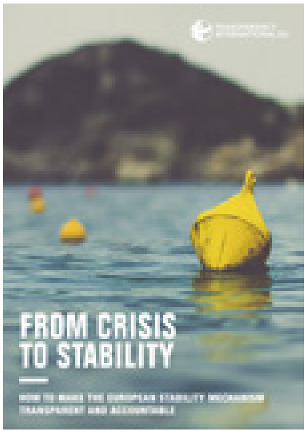
The ESM took a number of significant initiatives in 2016 to give citizens, parliamentarians, media, and all other stakeholders more insight into its work. In June 2016, the Board of Governors endorsed plans for more transparency on the meetings and decisions of the governing bodies of the ESM related to stability support programmes.

With this initiative, the ESM aims at further increasing the transparency of the decision-making over country programmes. The initiative follows on from a set of similar measures implemented by the Eurogroup, an informal body bringing together the 19 euro area finance ministers. The ESM has started publishing draft annotated agendas for meetings of its two main decision-making bodies, the Board of Governors and the Board of Directors.

In addition, the ESM publishes summaries of decisions of these meetings and programme-related documents once they are final and have been approved. Furthermore, it also makes public a range of draft documents related to financial assistance programmes before their final approval. These are draft memoranda of understanding, proposals by the Managing Director of the ESM for loan agreements, assessments by the institutions on risks to financial stability, documents relating to debt sustainability analysis, draft ESM terms of disbursements, compliance reports, and assessments of prior actions.

Documents published under this initiative can be found on the ESM website. There are certain exceptions which are stated in Article 17 of the ESM By-Laws, for instance when it is market sensitive.

In a further attempt to enhance transparency, at its Annual Meeting in June 2016 the ESM Board of Governors tasked the ESM with conducting an evaluation of past EFSF and ESM financial assistance programmes. Former ECB Executive Board member Gertrude Tumpel-Gugerell was appointed as the high-level independent evaluator leading the effort. The purpose of the evaluation is primarily to look into past programme activities to draw lessons for future activities. The evaluation is restricted to the completed programmes (Cyprus, Ireland, Portugal, and Spain) covering the period from the start of the programme negotiations until programme completion and also include the post-programme period up to the end of June 2016. This should help to promote the relevance, effectiveness, and efficiency of the programmes and further improve the decision-making processes. The evaluator will submit her findings to the ESM Board of Governors at the Board of Governors' Annual Meeting in June 2017.



"The ESM boasts world class audit arrangements, a code of conduct that ensures a high level of integrity, and a dedicated whistle-blowing procedure that reflects best practice."

Transparency International

The more regular features of our transparency culture also continued. During the past year, ESM Managing Director Klaus Regling was invited to speak before the European Parliament twice and also paid several visits to national parliaments. Furthermore, he held 14 public speeches and 13 regular press conferences. Management board members and other ESM staff members also speak at public events, including at conferences, seminars or academic gatherings. There is a continuous dialogue with the media, which results in frequent interviews and TV appearances. This effort seeks to enhance familiarity with the ESM's work across the European Union and elsewhere in the world. Last but not least, the ESM website was entirely redesigned in 2016, to provide easier and more comprehensive access to information on our activities.

Since the ESM is an intergovernmental organisation, it is indirectly accountable to national parliaments. The highest decision-making body of the institution, the ESM Board of Governors comprises the finance ministers representing the democratically elected governments of the ESM Members. A number of countries also require national parliamentary procedures to approve important ESM decisions.

ESM accountability is further reinforced through the extensive independent oversight provided by the Board of Auditors. The Board of Auditors' annual report to the Board of Governors as well as the ESM Management Comments in response to the report are made available to the national parliaments and supreme audit institutions of the ESM Members, as well as to the European Parliament and the European Court of Auditors.

Finally, the ESM also engaged in a dialogue with Transparency International, a prominent civil society organisation, which then published a report of its findings. The ESM provided a wealth of information about topics such as its governance structure, democratic control, integrity, and ethics policies.

MÁRIO CENTENO

Minister of Finance of the Portuguese Republic, ESM Governor

"The euro is a factor of confidence and of stability, both to member countries and to citizens. However, the euro is still in its infancy. Its overarching architecture – the EMU – needs to be completed. In a time of global uncertainties we must have the capacity to perfect the work started in Maastricht 25 years ago in order to foster growth for all the citizens in our countries."

03 INSTITUTIONAL FRAMEWORK AND ORGANISATION

The financial assistance toolkit of the ESM

The ESM has several different instruments at its disposal to fulfil its mission, though it has only used two to date. Principally, it has granted loans as part of a macroeconomic adjustment programme, such as the ones the ESM used in Cyprus and Greece, and those the EFSF delivered. The only other instrument used was an ESM loan to recapitalise banks in Spain. The ESM deploys these tools in exchange for conditionality, or reforms to address the causes of a Member's problems. Here's an overview of the ESM's full toolkit.

ESM LOANS

Goal: to assist ESM Members in significant need of financing, and which have lost access to the markets, either because they cannot find lenders or because the financing costs are so high their repayment would undermine the sustainability of public finances.

Conditional upon: the implementation of macroeconomic reform programmes, negotiated on behalf of the ESM by the European Commission in liaison with the ECB and, where possible, the IMF.

Used: in Ireland and Portugal (EFSF), Greece (EFSF and ESM), and Cyprus (ESM).

LOANS FOR INDIRECT BANK RECAPITALISATION

Goal: to assist an ESM Member by addressing those cases where the financial sector is primarily at the root of a crisis.

Conditional upon: reforms to financial supervision, corporate governance, and applicable law and regulations on bank recapitalisation, restructuring, and resolution.

Used: in Spain (ESM).

PRECAUTIONARY CREDIT LINE

Goal: to prevent crisis situations from emerging or developing, by helping countries whose economic conditions are sound to maintain market access by strengthening the credibility of their macroeconomic performance.

There are two types of credit lines:

A precautionary conditioned credit line is available to an ESM Member whose economic and financial situation is fundamentally sound and meets six specific eligibility criteria, beyond which there is no additional conditionality.

An enhanced conditions credit line is available to an ESM Member whose economic and financial situation remains sound but that does not comply with all the eligibility criteria for the first type. The ESM Member will need to take steps to address weaknesses and avoid market access problems.

Used: no.

PRIMARY MARKET PURCHASES

Goal: to support an ESM Member's bond auction, the ESM may buy debt securities at market prices in the primary market, in other words directly from the issuing ESM Members.

Conditional upon: no conditionality beyond the underlying programme, as this tool complements a regular loan instrument or a precautionary programme.

Used: no.

SECONDARY MARKET PURCHASES

Goal: to support the sound functioning of the government debt market when a lack of liquidity threatens the financial stability of an ESM Member whose economic and financial situation is otherwise fundamentally sound. This instrument can be used within or outside a macroeconomic adjustment programme.

Conditional upon: specific policy conditions apply for countries not under a programme.

Used: no.

DIRECT RECAPITALISATION INSTRUMENT (DRI)

Goal: to help remove a serious risk of contagion from the financial sector to the sovereign. The total amount available for this instrument is limited to €60 billion and can only be used for systemically important financial institutions, as defined in the relevant European Union legislation.

Conditional upon: measures to address the sources of difficulties in the financial sector and the general economic situation of the country. Eligible financial institutions are, for example, unable to attract sufficient capital from the private sector and existing burden-sharing arrangements on bank recapitalisation, restructuring, and resolution, in particular the bail-in requirements according to Article 27 of the Single Resolution Mechanism Regulation are insufficient.

Used: no.

WHAT'S NEW?

DRI REVIEW

The ESM recently fulfilled its commitment to review the DRI at least every two years. The ESM Board of Directors completed its review in October 2016 and decided not to make any changes to this instrument.

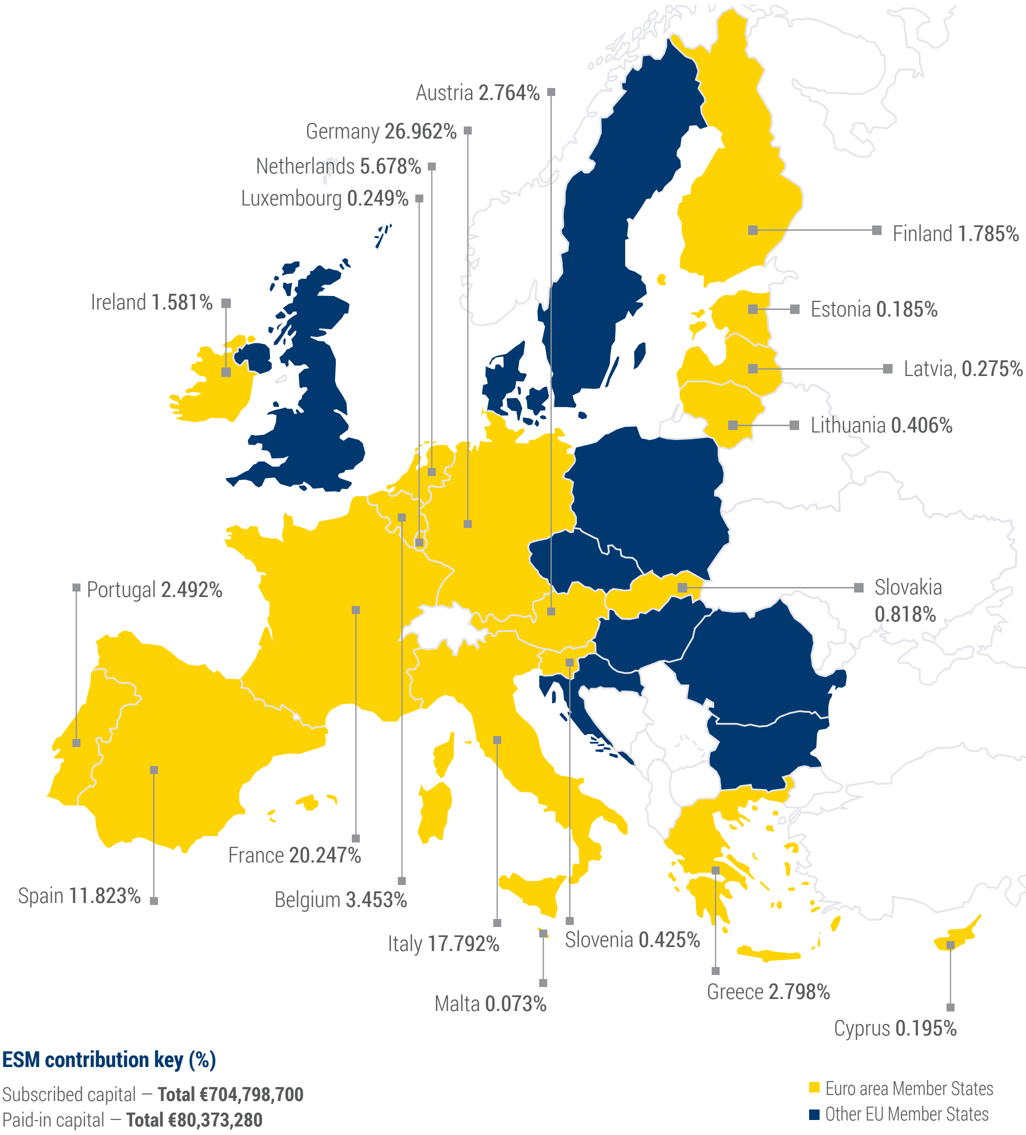
SRB BRIDGE FINANCING ARRANGEMENT FOR MEMBER STATES

As of 2016, banking union members have granted credit lines to the banking resolution authority in Europe, the Single Resolution Board, to ensure it has sufficient financing. The ESM decision-making bodies adopted changes to the ESM lending documentation to enable ESM Members to request backstop assistance from the ESM if they do not have the funds to meet this obligation. ESM Members may request financial support for this purpose under three existing instruments: a macroeconomic adjustment programme, a precautionary credit line, or an indirect bank recapitalisation loan. In each case, the relevant conditionality would apply.

GOVERNANCE

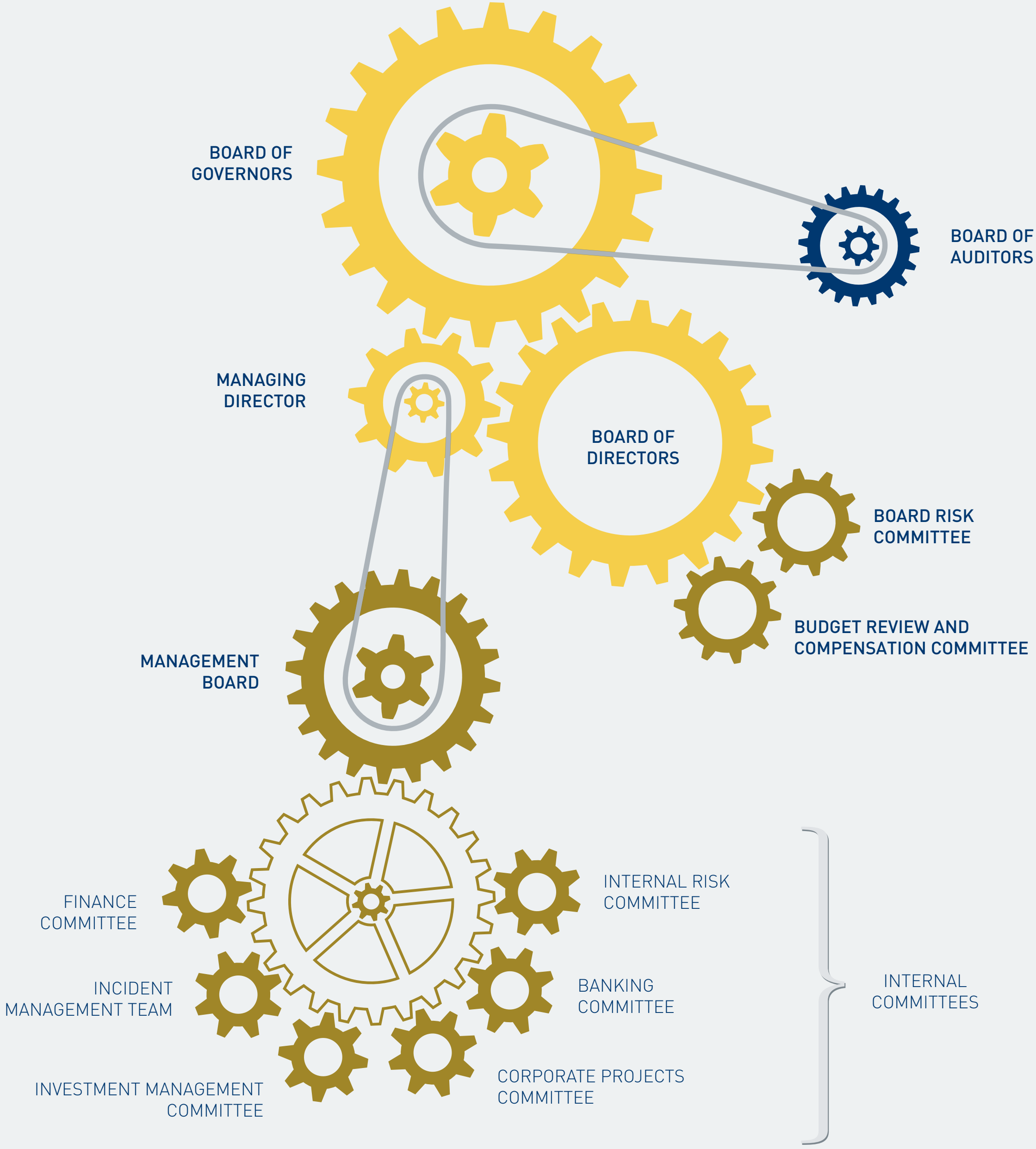
ESM shareholders

The ESM shareholders are the 19 euro area Member States, which are also referred to as ESM Members. Each member has contributed to the ESM's authorised capital based on the ESM Members' respective shares of the European Union's total population and GDP. The authorised capital amounts to €704.8 billion and is divided into paid-in and callable capital. The paid-in capital currently stands at €80.4 billion.



Notes: As of 1 April 2017.
The accession of new ESM Members is factored into the capital key, reducing the existing ESM Members' contribution keys. Individual nominal capital subscriptions and paid-in capital amounts remain unchanged for the existing ESM Members. In line with Article 42 of the ESM Treaty, ESM Members with GDP per capita of less than 75% of the European Union average in the year immediately preceding their ESM accession benefit from a temporary correction mechanism. During this period, the initial capital subscription of the ESM Member benefiting from the correction is lower, thus leading temporarily to a lower paid-in capital contribution. Once this period ends, the ESM Member must deposit the remaining amount. Latvia officially became the 18th ESM Member on 13 March 2014. Latvia qualifies for a temporary correction and is making the payments of paid-in capital in five annual instalments of €44.24 million each. 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 and is making the payments of paid-in capital in five annual instalments of €65.44 million each. Once the temporary correction comes to an end in 2027, Lithuania must deposit the remaining €159.4 million.
Source: ESM

Governance structure



For more information on our governance structure, visit our website.

BOARD OF GOVERNORS

Annual Meeting of the Board of Governors

The 2016 Annual Meeting took place in the new conference space at the ESM premises in Luxembourg on 16 June 2016.

On 16 June 2016, the Board of Governors held its fourth Annual Meeting at the ESM premises in Luxembourg, during which it approved the ESM 2015 Annual Report as drawn up by the ESM Managing Director.

The Managing Director presented the Governors with an overview of key ESM developments and institutional affairs over the past financial year. 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 2015 financial statements.

Members of the Board of Governors

NETHERLANDS

Jeroen Dijsselbloem

Chairperson of the Board of Governors,
Minister of Finance,
Governor since 27 September 2012

SPAIN

Luis de Guindos Jurado

Minister of Economy, Industry and Competitiveness,
Governor since 27 September 2012

BELGIUM

Johan Van Overtveldt

Minister of Finance,
Governor since 15 December 2014

FRANCE

Michel Sapin

Minister for the Economy and Finance,
Governor since 2 April 2014

GERMANY

Wolfgang Schäuble

Federal Minister of Finance,
Governor since 27 September 2012

ITALY

Pier Carlo Padoan

Minister of Economy and Finance,
Governor since 22 February 2014

ESTONIA

Sven Sester

Minister of Finance,
Governor since 9 April 2015

CYPRUS

Harris Georgiades

Minister of Finance,
Governor since 3 April 2013

IRELAND

Michael Noonan

Minister of Finance,
Governor since 27 September 2012

LATVIA

Dana Reizniece-Ozola

Minister of Finance,
Governor since 22 March 2016
replacing Jānis Reirs,
Governor since 5 November 2014

GREECE

Euclid Tsakalotos

Minister of Finance,
Governor since 6 July 2015

LITHUANIA

Vilius Šapoka

Minister of Finance,
Governor since 13 December 2016
replacing Rasa Budbergytė,
Governor since 23 June 2016
replacing Rimantas Šadžius,
Governor since 3 February 2015

LUXEMBOURG

Pierre Gramegna

Minister of Finance,
Governor since 4 December 2013

MALTA

Edward Scicluna

Minister for 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

SLOVENIA

Mateja Vraničar Erman

Minister of Finance,
Governor since 21 September 2016
replacing Dušan Mramor,
Governor since 18 September 2014

SLOVAKIA

Peter Kažimír

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

FINLAND

Petteri Orpo

Minister of Finance,
Governor since 29 June 2016
replacing Alexander Stubb,
Governor since 11 June 2015

Shareholder engagement

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

Furthermore, in 2016 the ESM organised its third annual Shareholders' Day bringing together ESM staff and 37 representatives from ESM Members' finance ministries with a view to encouraging closer cooperation and exchanging day-to-day work experiences on ESM-related matters. For the first time, an external speaker, Lucio Vinhas de Souza from the European Political Strategy Centre, delivered a keynote presentation on the role of the euro and the future of the European Union and the euro area.

The ESM welcomed representatives from the finance ministries of ESM Members at its annual Shareholders' Day in September 2016.

BOARD OF DIRECTORS

Members of the Board of Directors

CHAIR OF THE MEETINGS
OF THE BOARD OF DIRECTORS

Klaus Regling

ESM Managing Director

BELGIUM

Steven Costers

Counselor General, Ministry of Finance, appointed on 1 May 2015

GERMANY

Thomas Steffen

State Secretary, Federal Ministry of Finance, appointed on 24 September 2012
Member of the Budget Review and Compensation Committee since 9 October 2012, reappointed until 9 October 2017

ESTONIA

Märten Ross

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

IRELAND

Nicholas O'Brien

Assistant Secretary General, Department of Finance, appointed on 3 July 2014
Member of the Budget Review and Compensation Committee since 30 September 2014, reappointed until 8 October 2019

GREECE

George Chouliarakis

Alternate Minister of Finance, appointed on 4 February 2015

SPAIN

Emma Navarro Aguilera

Secretary General for Treasury and Financial Policy, Ministry of Economy, Industry and Competitiveness, appointed on 22 November 2016, replacing Rosa María Sánchez-Yebra Alonso, originally appointed on 25 September 2014
Member of the Budget Review and Compensation Committee since 9 February 2017, appointed until 9 October 2017

FRANCE

Odile Renaud Basso

Director General of the Treasury, Ministry of Finance and Public Accounts, appointed on 30 June 2016, replacing Bruno Bézard, originally appointed on 2 July 2014
Member of the Board Risk Committee since 10 February 2017, appointed until 9 October 2017

ITALY

Vincenzo La Via

Director General of the Treasury, Ministry of Economy and Finance, appointed on 8 October 2012
Member and Chairperson of the Board Risk Committee since 9 October 2012, reappointed until 8 October 2018

CYPRUS

George Panteli

Head of the 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

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 Budget Review and Compensation Committee since 24 April 2014, reappointed until 8 October 2018

MALTA

Alfred Camilleri

Permanent Secretary, Ministry of Finance, appointed on 8 October 2012
Member of the Budget Review and Compensation Committee since 9 October 2012, reappointed until 8 October 2019
Chairperson of the Budget Review and Compensation Committee since 24 April 2014, reappointed until 8 October 2019

NETHERLANDS

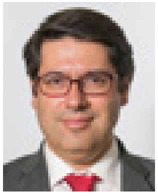
Hans Vijlbrief

Treasurer-General, Ministry of Finance, appointed on 27 September 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, reappointed until 8 October 2019



PORTUGAL

Ricardo Mourinho Félix

Deputy Finance Minister and Secretary of State for Finance, Ministry of Finance, appointed on 7 December 2015
Member of the Board Risk Committee from 7 April 2016, reappointed until 8 October 2019

SLOVENIA

Gorazd Renčelj

State Secretary, Ministry of Finance, appointed on 10 February 2017 replacing Irena Sodin, originally appointed on 24 October 2014

SLOVAKIA

Peter Paluš

Head of Financial Unit at Permanent Representation of Slovakia to the European Union, appointed on 22 February 2017 replacing Ivan Lesay, originally appointed on 24 June 2015

FINLAND

Tuomas Saarenheimo

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

BOARD OF AUDITORS

The Board of Auditors is an independent oversight body of the ESM. It 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 Board of Auditors is composed of five members appointed by the Board of Governors in line with Article 24 of the By-Laws. New members of the Board of Auditors are appointed for a non-renewable term of three years.

In 2016, the Board of Auditors held eight 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 on ESM activities, the ESM governing bodies, and other relevant issues and developments.

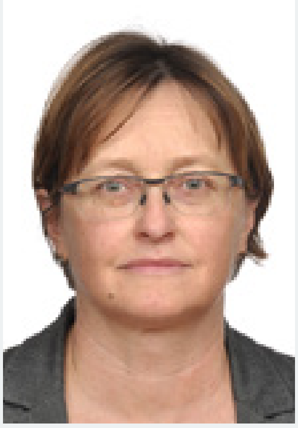
The ESM also provided the Board of Auditors with presentations and written opinions by ESM management and external experts. The Board of Auditors met regularly with the internal audit function and monitored and reviewed the work and independence of the external auditors. Furthermore, the Board of Auditors carried out an audit of ESM investment operations and acted as observers of the ESM external audit procurement process for the financial years 2017–2019. In fulfilling its role, the Board of Auditors also reviewed the ESM financial statements as at 31 December 2016 and the working papers of the external auditor.

In addition to its annual report in respect of the ESM financial statements included in the ESM annual report, 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, and to the European Parliament, and the European Court of Auditors.

MATEJA VRANIČAR ERMAN

Minister of Finance of the Republic of Slovenia, ESM Governor

“Today, the euro is a key anchor for responsible economic policy making of the European Union. It enables economic integration to be solidly established on a permanent basis. With the creation of institutions supporting its function, it enhances overall resilience and contributes to transparency and responsible economic behaviour. The existence of the euro fosters economic coordination for the benefit of the participating members and the European Union at large. For a small and open economy like Slovenia, it decreases the cost of trade and financing and facilitates foreign direct investment. All these factors enhance competitiveness and welfare.”



Members of the Board of Auditors

Kevin Cardiff

Chairperson since 21 February 2017
Member since 17 December 2016
Appointed upon nomination by the European Court of Auditors, replacing Igors Ludboržs whose term expired on 16 December 2016.

François-Roger Cazala

Vice Chairperson since 21 February 2017
Member since 8 October 2016
Appointed upon nomination by the French Supreme Audit Institution, replacing Ulrich Graf whose term expired on 7 October 2016.

Günter Borgel

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

Andrew Harkness

Member since 8 October 2015
Appointed upon nomination by the Irish Supreme Audit Institution.

Jean Guill

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

Note: In line with Article 24 of the By-Laws two members are appointed upon proposal of the Chairperson of the Board of Governors, two members upon nomination by the supreme audit institutions of the ESM Members based on a system of rotation, and one member by the European Court of Auditors.

INTERNAL CONTROL FRAMEWORK

The ESM recognises the importance of adequate 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. The internal control framework is embedded in the institution and reflects the nature, complexity, and risks inherent in the ESM activities.

ESM internal controls are underpinned by the three lines of defence governance model established by the Board of Directors and are aligned with the principles of the Basel Committee's Framework for Internal Control Systems in Banking Organisations.[31]

The Board of Directors, directly and through the Board Risk Committee, holds periodic discussions with management on the state of the ESM internal controls.

The Managing Director, under the direction of the Board of Directors, is responsible for the ongoing maintenance of the ESM internal control framework. The Managing Director, assisted by the Management Board, fulfils this responsibility by: setting a strong tone at the top; displaying a commitment to integrity and ethical values; exercising oversight of internal controls across all areas of the ESM; and assigning clear roles and responsibilities. Each year, the Managing Director issues a management report on the state of ESM internal controls to the Board of Directors and the Board of Auditors.

Entity level controls include management oversight and control culture, risk recognition and assessment, reliable information systems, availability of information relevant to decision making, and processes for monitoring and correcting deficiencies.

Process level controls include operational controls embedded in key processes and transactions. Such controls exist in all processes and transactions affecting the ESM accounts.

Information technology (IT) controls include general controls over the IT environment, computer operations, access to programs and data, program development, change management, and automated transaction processing controls.

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

Participants discuss internal controls at the first Internal Control Forum of European International Financial Institutions, organised and hosted by the ESM on 20 and 21 June 2016.

There are inherent limitations to the effectiveness of any system of internal controls, including the possibility of human error or circumvention of overriding controls. Therefore, even an effective internal control framework can provide only reasonable assurance. Based on its 31 December 2016 assessment, management found no material or significant deficiencies in internal controls. Also, it identified no instances of fraud in 2016.

Internal Audit provides an independent assurance on the established internal controls and procedures as part of the regular audit cycle. Internal Audit independently reviews the entity level controls on an annual basis.

The external auditor gains a sufficient understanding of ESM internal controls to provide reasonable assurance on the accuracy of the ESM's financial statements.

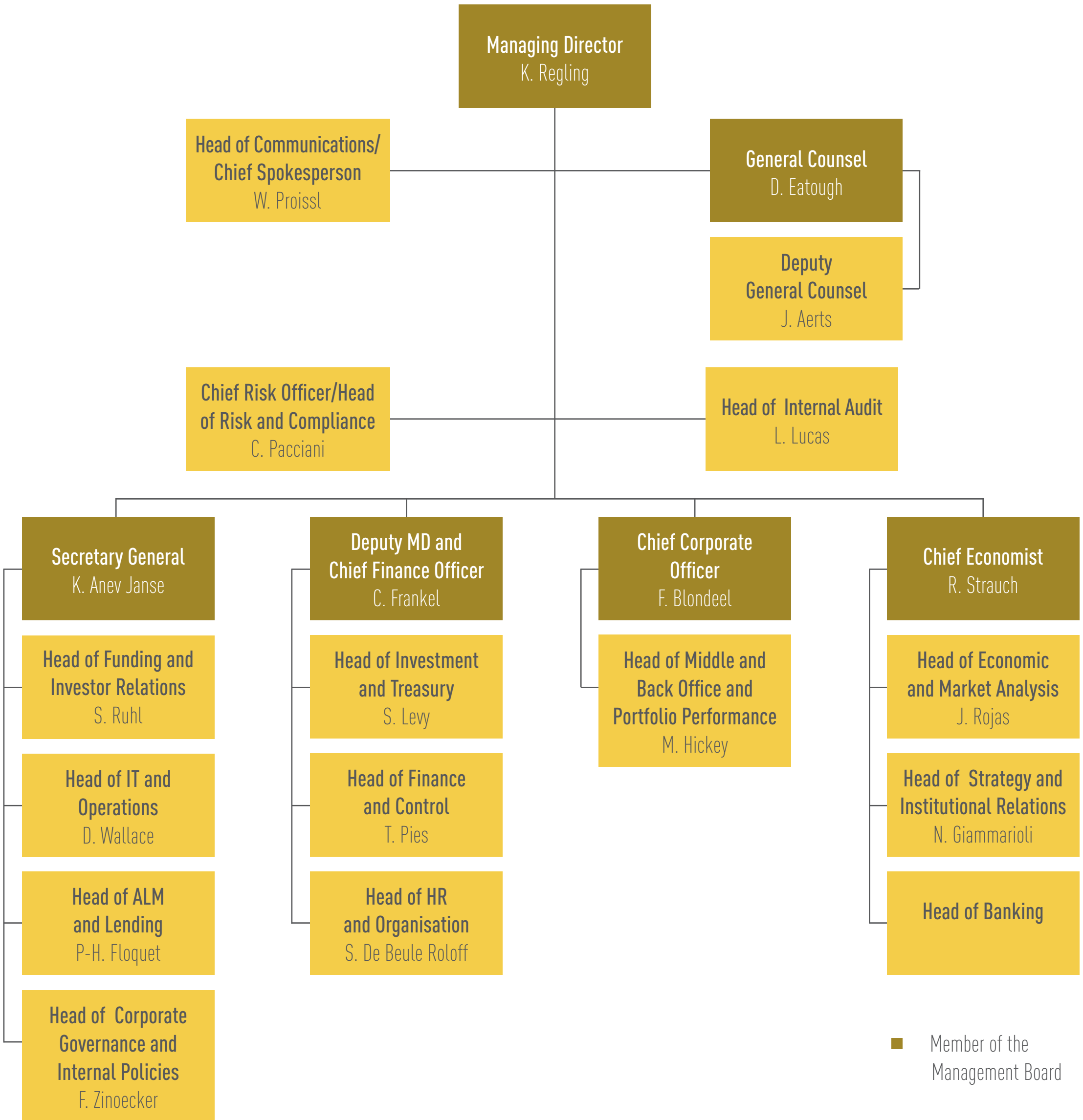
The ESM continuously benchmarks its internal control framework against best practices and fosters an active exchange on these topics with peer organisations. In June 2016, the ESM organised the first Internal Control Forum among European institutions.

PETER KAŽIMÍR

Deputy Prime Minister and Minister of Finance of the Slovak Republic, ESM Governor

"Despite the crises of the past years, the euro remains one of the most attractive global currencies. It encourages international trade and provides assurances to businesses and investors. Most importantly, the euro is the symbol of the European integration project, which remains the best option for all of us."

ESM ORGANISATIONAL STRUCTURE



Visit our website for more information on our organisational structure and a description of the activities of the various departments.

The Management Board and Heads of Division

PETTERI ORPO

Minister of Finance of the Republic of Finland, ESM Governor

"The euro has provided stable monetary conditions. This has benefited households and enterprises by providing price stability and lower interest rates."

04 FINANCIAL REPORT

Balance sheet

At year-end, the total balance sheet of the ESM was €793.1 billion. Compared to 31 December 2015, the balance sheet increased by €14.2 billion, mainly due to new loan disbursements in 2016. The ESM disbursed €10.3 billion in loans to Greece and received early repayments from Spain for €1 billion.

To provide financial assistance to the beneficiary Member States, the ESM relies on its funding activity. In 2016 the total liability in respect of debts evidenced by certificates increased by 19% to €85.7 billion (€72 billion in 2015), reflecting the increase in lending activity and in the liquidity buffer.

As of 31 December 2016, the total €80.3 billion of paid-in capital 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 2016, the fair value reserve was €183.2 million, compared to €127.7 million as of 31 December 2015. The variation reflects the appreciation of the investments' value on the market compared to the previous year, largely due to the decrease in yields.

Profit and loss account

The ESM recorded a net income[32] of €568.8 million for the financial year 2016, compared to €729.4 million in 2015.

In 2016, the interest income on loans to beneficiary Member States was €684.2 million. Debt securities issued generated an interest expense of €525.9 million in 2016 and, due to negative yields on short-term notes, an interest income of €76.2 million. The net realised result from the sales of debt securities in the paid-in capital portfolio was €287.1 million in 2016, €151.7 million less than 2015. Interest income on debt securities decreased by €64.1 million due to decreasing yields in the portfolio.

Operating costs including depreciation of fixed assets were €54.1 million, compared to €50.0 million in 2015, mainly due to additional staff and related overhead costs. The ESM provides certain administrative services to the EFSF, and therefore charges it service fees of €26.7 million, which are recognised as Other operating income. The ESM continues to focus on budgetary discipline and effective cost control.

Outlook for 2017

The ESM has actively diversified its investments and continues to look for additional measures to mitigate the impact of the negative yield environment, in line with its guidelines and its mandate. Nevertheless, the persistence of this environment will negatively affect the ESM's net income in 2017.

[32] The net income of the ESM is mainly driven by the interest margin on its lending activity and the return on the investment of its paid-in capital. The ESM Pricing Policy defines the distinct elements of the total cost of a loan.

Balance sheet

As at 31 December 2016 (in €'000)

	Notes	31.12.2016	31.12.2015
ASSETS			
Cash in hand, balances with central banks and post office banks	5	64,922,796	54,831,051
Loans and advances to credit institutions			
(a) other loans and advances	6	1,514	186,514
		1,514	186,514
Loans and advances to euro area Member States	7	72,732,950	63,445,582
Debt securities including fixed-income securities	8		
(a) issued by public bodies		20,986,061	27,105,429
(b) issued by other borrowers		9,476,986	8,329,546
		30,463,047	35,434,975
Intangible assets	9	47	25
Tangible assets	10	4,189	2,923
Subscribed capital unpaid	2.14/15	624,250,300	624,250,300
Subscribed capital called but not paid	2.14/15	284,800	394,480
Prepayments and accrued income	11	451,483	318,005
Total assets		793,111,126	778,863,855
LIABILITIES			
Debts evidenced by certificates	12		
(a) debt securities in issue		85,658,968	72,054,845
		85,658,968	72,054,845
Other liabilities	13	12,068	9,771
Accruals and deferred income	14	462,731	446,135
Total liabilities		86,133,767	72,510,751
SHAREHOLDERS' EQUITY			
Subscribed capital	2.14/15	704,798,700	704,798,700
Fair value reserve	8	183,194	127,703
Reserve fund	2.7.1/16	1,426,701	697,326
Profit for the financial year		568,764	729,375
Total shareholders' equity		706,977,359	706,353,104
Total equity and liabilities		793,111,126	778,863,855

The accompanying notes form an integral part of these financial statements.

Off-balance sheet

As at 31 December 2016 (in €'000)

	Notes	31.12.2016	31.12.2015
OFF-BALANCE SHEET			
Commitments	24		
(a) undisbursed loans to euro area Member States		54,274,000	67,265,572
		54,274,000	**67,265,572**
Other items	25		
(a) nominal value of currency swap contracts			
- receivable		900,997	2,374,954
- payable		(741,301)	(2,448,428)
(b) nominal value of currency forward contracts			
- receivable		2,356	43
- payable		(2,227)	(46)

Profit and loss account

For the financial year ending 31 December 2016 (in €'000)

	Notes	2016	2015
Interest receivable and similar income			
(a) on loans and advances to credit institutions		84	1,603
(b) on loans and advances to euro area Member States	17	684,197	483,717
(c) on debt securities including fixed-income securities	18	77,177	138,301
(d) on debts issued	19	76,204	26,020
(e) other	25.1	4,164	1,297
		841,826	**650,938**
Interest payable and similar charges			
(a) on debts issued	19	(525,862)	(333,703)
(b) on debt securities including fixed-income securities	18	(3,686)	(663)
(c) other	25.1	(3,222)	(559)
		(532,770)	**(334,925)**
Commissions payable		**(11)**	**(18)**
Other operating income	20	**26,737**	**24,568**
Net profit on financial operations	21	**287,073**	**438,777**
General administrative expenses			
(a) staff costs	22	(27,331)	(22,453)
- wages and salaries		(20,213)	(16,670)
- social security		(7,118)	(5,783)
of which relating to pension		(6,084)	(4,899)
(b) other administrative expenses	23	(25,746)	(26,666)
		(53,077)	**(49,119)**
Value adjustments in respect of intangible and tangible assets	9/10	**(1,014)**	**(846)**
Profit for the financial year		568,764	729,375

The accompanying notes form an integral part of these financial statements.

Statement of changes in equity

For the financial year ending 31 December 2016 (in €'000)

	Subscribed capital	Fair value reserve	Reserve fund	Profit 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
Change in fair value reserve	-	(385,160)	-	-	-	(385,160)
At 31 December 2015	704,798,700	127,703	697,326	-	729,375	706,353,104

	Subscribed capital	Fair value reserve	Reserve fund	Profit brought forward	Profit for the financial year	Total
At 1 January 2016	704,798,700	127,703	697,326	-	729,375	706,353,104
Subscription of capital	-	-	-	-	-	-
Allocation of the profit of 2015	-	-	-	729,375	(729,375)	-
Allocation of profit brought forward to the reserve fund	-	-	729,375	(729,375)	-	-
Profit for the financial year	-	-	-	-	568,764	568,764
Change in fair value reserve	-	55,491	-	-	-	55,491
At 31 December 2016	704,798,700	183,194	1,426,701	-	568,764	706,977,359

The accompanying notes form an integral part of these financial statements.

Statement of cash flows

For the financial year ending 31 December 2016 (in €'000)

	2016	2015
Cash flows from operating activities:		
Profit for the financial year	568,764	729,375
Adjustments for:		
Value adjustments in respect of tangible and intangible assets	1,014	846
Changes in:		
Tangible and intangible assets	(2,302)	(261)
Other liabilities	2,297	(13,820)
Accrued interest and interest received	(935,683)	(1,130,970)
Prepayments	(176,539)	65,067
Accruals and deferred income and interest paid	409,714	356,850
Out of which:		
Interest received	978,744	1,342,959
Up-front service fee received	51,500	110,128
Interest paid	(444,618)	(294,210)
Net cash provided by operating activities	**452,891**	**1,165,964**
Cash flows from investing activities		
Change in debt securities including fixed-income securities	5,027,419	25,830,289
Change in loans and advances to credit institutions	185,000	18,470,000
Net loans disbursed during the year	(9,287,368)	(18,024,122)
Net cash provided/used in investing activities	**(4,074,949)**	**26,276,167**
Cash flows from financing activities		
Payment of capital	109,680	109,680
Changes in debt securities in issue	13,604,123	22,891,237
Net cash provided by financing activities	**13,713,803**	**23,000,917**
Net increase/decrease in cash and cash equivalents	10,091,745	50,443,048
Cash and cash equivalents at the beginning of the financial year	54,831,051	4,388,003
Cash and cash equivalents at the end of the financial year	**64,922,796**	**54,831,051**

The accompanying notes form an integral part of these financial statements.

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 2016 to 31 December 2016, while comparative figures cover the period from 1 January 2015 to 31 December 2015.

On a proposal from the Managing Director, the Board of Directors adopted the financial statements on 30 March 2017 and authorised their submission to the Board of Governors for approval at their 15 June 2017 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 financial 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. This instrument is currently not used. The specific elements are detailed in the ESM pricing policy.

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 €37.0 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 an 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.

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.

On 11 November 2016, the ESM received the fourth early repayment from Spain of €1 billion, which was approved by the ESM Board of Directors on 7 November 2016.

By 31 December 2016, Spain had, in total, repaid €6.6 billion of its financial assistance. All 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 disbursed €6.3 billion, and the International Monetary Fund (IMF) contributed around €1 billion. Cyprus exited successfully from its ESM programme 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 another €0.6 billion in 2015.

The financial assistance facility was 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 included budgetary financing, the redemption of medium- and long-term debt, and the recapitalisation of financial institutions. They excluded 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 in 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 expired 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.

On 17 June 2016, the Board of Directors approved the disbursement of €7.5 billion to Greece as the first disbursement under the second tranche of €10.3 billion. This disbursement was used for debt servicing and to help clear domestic arrears.

On 25 October 2016, the Board of Directors approved the disbursement of €2.8 billion to Greece as the second disbursement under the second tranche of €10.3 billion. This €2.8 billion disbursement consisted of two parts: €1.1 billion was approved for release following the full implementation of a set of 15 milestones by the Greek authorities, and was used for debt servicing. A further €1.7 billion was disbursed to a dedicated account for clearing arrears after a positive assessment of the clearance of net arrears by Greece.

2. Summary of significant accounting policies

The principal accounting policies applied in the preparation of these financial statements are set out below. The accounting policies have been consistently applied by the ESM. Certain comparative figures have been reclassified, as disclosed in Notes 18 and 19.

2.1. Basis of presentation

The accompanying financial statements are prepared and presented in accordance with 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.

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

The preparation of financial statements in conformity with the Directives requires the use of certain critical accounting estimates. It also requires management[33] 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 2016 and 2015, 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.

[33] 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 the 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[34] (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 offset 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 portfolios for 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 ESM Investment Guidelines 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 Investment Guidelines 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 Investment Guidelines, 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.

[34] 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 Investment Guidelines specify, 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.

The assets of the reserve fund shall be invested in full in the short-term tranche.

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 instruments.

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 the asset is sold, collected or otherwise disposed of, or until the asset is determined to be impaired.

If the 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, and ensure market access, even in a difficult market environment.

As per the ESM Investment Guidelines, the management of the liquidity buffer follows the same investment restrictions as the short-term tranche of the paid-in capital described in Note 2.7.1.

2.7.3. 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 2016, 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 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 assets and financial liabilities are recognised on an accrual basis within 'Interest receivable and similar income' and 'Interest payable and similar charges' in the profit and loss account.

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 applied 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 employer as well as from the 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 risk, and
- operational risk.

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 the 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 of its investment portfolio.

The ESM operates under the principles of the three lines of defence approach: 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 and Compliance Department. The Risk and Compliance 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 and Compliance Department and is a direct report of the Managing Director. The Chief Risk Officer is responsible and accountable for informing the Managing Director of 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 an 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. On a periodical basis, the IRC conducts 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 and 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 and derives from investment in securities of the paid-in capital and excess liquidity. Credit concentration risk is defined as the potential for loss arising from undiversified, correlated exposure to a particular group of counterparties.

Given the nature of the ESM's mandate, where credit risk from lending arises as a result of support to beneficiary Member States under a FFA, the credit risk in the ESM's lending exposure is accepted. Note 4 below further describes the ESM's treatment of loans to euro area Member States.

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

The following table shows the 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)	Exposure 31.12.2016	Exposure 31.12.2015
Cash in hand, balances with central banks and post office banks	64,922,796	54,831,051
Loans and advances to credit institutions	1,514	186,514
Debt securities including fixed-income securities	30,463,047	35,434,975
On balance sheet credit risk exposure	**95,387,357**	**90,452,540**
Off balance sheet items	903,353	2,374,997
Credit risk exposure	**96,290,710**	**92,827,537**

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 31.12.2016
Cash in hand, balances with central banks and post office banks	not rated**	64,919,468
	AA	3,328
Loans and advances to credit institutions	AA	1,514
Debt securities including fixed-income securities	AAA	17,900,010
	AA+	2,858,372
	AA	6,558,157
	AA-	763,098
	A+	11,306
	A	2,372,104
Total		**95,387,357**

* 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 31.12.2015
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 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 Guidelines require. 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 regard to derivative transactions, the ESM had only foreign exchange derivative transactions in 2016. On 31 December 2016, all derivative financial instruments had a final maturity of a maximum of two years and all of them were concluded with a euro area central bank or with the Bank for International Settlements.

3.3. Market risk

Market risk is the risk of loss arising from changes in the value of financial assets and liabilities due to fluctuations in interest rates, foreign exchange rates, and other factors affecting the price of securities / financial instruments (e.g. credit spreads and basis risk).

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 following market movements, yield curve shifts, and changes in interest rate credit spread.

Paid-in capital investments are subject to interest rate risk. This risk may 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. Funding costs arising from refinancing risk are passed through to beneficiary Member States under financial assistance, as defined by the ESM Pricing Policy. The ESM measures and monitors this risk continually, since it is generally the case that long-dated assets will be funded by shorter-dated liabilities.

Non-structural interest rate risk is the risk of loss due to an adverse change in the overall level of interest rates affecting the value of investments. Non-structural interest rate risk is controlled and monitored on a daily basis through risk indicators like duration limits, sensitivities, "1 day Value at Risk" with a 99% level of confidence and stress tests. The interest rate risk on the Short Term Tranche and the Medium to Long Term Tranche is also framed by capital preservation and volatility limits as described and published in the ESM Investment Guidelines.

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 currency exposure, in line with the risk appetite of the institution.

The ESM is exposed to currency risk whenever there is a currency mismatch between its assets and liabilities. In 2015 and 2016, the exclusive potential source of currency risk were the non-euro investments made in the investment portfolios. The ESM had investment activities in foreign currency assets, mainly Danish krona and Japanese yen.

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

31 December 2016 (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	64,922,796	-	-	-	**64,922,796**
Loans and advances to credit institutions	1,514	-	-	-	**1,514**
Loans and advances to euro area Member States	72,732,950	-	-	-	**72,732,950**
Debt securities including fixed-income securities	28,090,943	2,372,104	-	-	**30,463,047**
Prepayments and accrued income	449,161	2,322	-	-	**451,483**
Total financial assets	**166,197,364**	**2,374,426**	**-**	**-**	**168,571,790**
LIABILITIES					
Debt securities in issue	85,658,968	-	-	-	**85,658,968**
Other liabilities	12,068	-	-	-	**12,068**
Accruals and deferred income	462,598	133	-	-	**462,731**
Total financial liabilities	**86,133,634**	**133**	**-**	**-**	**86,133,767**
Shareholders' equity*	82,442,259	-	-	-	82,442,259
Total shareholders' equity	**82,442,259**	**-**	**-**	**-**	**82,442,259**
Off-balance sheet derivatives	**2,527,164**	**(2,367,339)**	**-**	**-**	**159,825**
Net of financial position	**148,635**	**6,954**	**-**	**-**	**155,589**

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)**

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

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 by assessing its funding liquidity risk and market liquidity risk.

Funding liquidity risk is defined as 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). 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. At the end of December 2016, the ESM's liquidity buffer stood at €13.0 billion (2015: €11.4 billion).

Market liquidity risk is defined as the potential for loss arising from a position that cannot easily be liquidated without significantly and negatively influencing its market price. Market liquidity risk is minimised by investing 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.

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 2016 (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	64,922,796	-	-	-	**64,922,796**
Loans and advances to credit institutions	1,514	-	-	-	**1,514**
Loans and advances to euro area Member States	-	-	-	72,732,950	**72,732,950**
Debt securities including fixed-income securities	2,101,512	3,715,218	11,609,885	13,036,432	**30,463,047**
Prepayments and accrued income	222,673	228,810	-	-	**451,483**
Total financial assets	**67,248,495**	**3,944,028**	**11,609,885**	**85,769,382**	**168,571,790**
LIABILITIES					
Debt securities in issue	10,581,157	7,531,971	31,138,151	36,407,689	**85,658,968**
Other liabilities	12,068	-	-	-	**12,068**
Accruals and deferred income	121,924	155,842	161,667	23,298	**462,731**
Total financial liabilities	**10,715,149**	**7,687,813**	**31,299,818**	**36,430,987**	**86,133,767**
Shareholders' equity*	-	-	-	82,442,259	**82,442,259**
Total shareholders' equity**	**-**	**-**	**-**	**82,442,259**	**82,442,259**
Net of financial position	**56,533,346**	**(3,743,785)**	**(19,689,933)**	**(33,103,864)**	**(4,236)**

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	-	-	-	63,445,582	**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**	**19,102,114**	**74,856,075**	**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)**	**(11,497,561)**	**(25,267,803)**	**(2,948)**

* 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. The categorisation of the ESM operational risks is based on guidance from 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 2016.

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 and Compliance 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 the ESM's top operational risks (based on potential likelihood and impact).The Risk and Compliance Department monitors these risks and reports on them to the Internal Risk Committee and to 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 and close monitoring of debt sustainability and conditionality attached to all financial assistance to beneficiary Member States, as negotiated with the European Commission in liaison with the 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. As part of its early warning procedure, the ESM assesses the ability of a beneficiary Member State to repay its obligations. Findings are summarised in a regular report, which is considered by the Internal Risk Committee.

The ESM provided financial assistance to Spain for the recapitalisation of its financial sector which must be repaid by 2027. The ESM also provided financial assistance to Cyprus, which implemented 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's 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 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)	31.12.2016	31.12.2015
Current account balances with euro area central banks	64,919,468	54,823,769
Current account balances with other banks*	3,328	7,282
Total cash in hand, balances with central banks and post office banks	**64,922,796**	**54,831,051**

* 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)	31.12.2016	31.12.2015
Money market deposits with other banks	-	185,000
Other deposits	1,514	1,514
Total loans and advances to credit institutions	**1,514**	**186,514**

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

In accordance with Article 9 of the ESM Treaty, the Board of Governors may decide to grant financial assistance in the form of a loan to an ESM Member (refer to Note 26).

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 as at 31 December 2016
Loans to euro area Member States			
- to Spain	5	34,721,460	34,721,460
- to Cyprus	9	6,300,000	6,300,000
- to Greece	7	31,702,428	31,711,490
Total	**21**	**72,723,888**	**72,732,950**

	No. of loans	Nominal amount	Clean carrying value as at 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**

The following table shows the movements of the loans to euro area Member States during 2015 and 2016:

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)*
Premiums/discounts amortisation	(914)
31 December 2015 balance	**63,445,582**

(in €'000)	
1 January 2016 balance	**63,445,582**
New disbursements	10,300,000
- to Greece	*10,300,000*
Early repayments	(1,000,000)
- from Spain	*(1,000,000)*
Premiums/discounts amortisation	(12,632)
31 December 2016 balance	**72,732,950**

8. Debt securities including fixed-income securities

The following table shows the details of the debt securities valuation and their classification on 31 December 2016:

(in €'000)	Clean amortised cost	Unrealised gains	Clean fair (carrying) value	Nominal amount
Paid-in capital portfolio	30,279,853	183,194	30,463,047	29,387,122

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

On 31 December 2016, the clean amortised cost of the debt securities was €30.3 billion (31 December 2015: €35.3 billion), against a clean fair value of €30.5 billion (31 December 2015: €35.4 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. The Risk and Compliance Department defines a limit structure to mitigate the maximum exposure per issuer.

On 31 December 2016, 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 €4.6 billion (31 December 2015: of €5.3 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 other issuers. Public bodies cover central banks, central governments, regional governments, local governments, supranational institutions and governmental agencies. On 31 December 2016, debt securities issued by public bodies amounted to €21 billion

(31 December 2015: €27.1 billion), while debt securities issued by other borrowers amounted to €9.5 billion (31 December 2015: €8.3 billion).

Starting from 2015, the ESM has 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 during 2016:

(in €'000)	Software	Total intangible assets
Historical cost		
1 January 2016 balance	211	211
Additions	73	73
Disposals	(126)	(126)
31 December 2016 balance	158	158
Accumulated amortisation		
1 January 2016 balance	(186)	(186)
Amortisation	(51)	(51)
Of the disposed assets	126	126
31 December 2016 balance	(111)	(111)
Net book value		
31 December 2016 balance	47	47
31 December 2015 balance	25	25

10. Tangible assets

The following table shows the movements of tangible assets during 2016:

(in €'000)	Fixtures and fittings	Furniture and office equipment	Total tangible assets
Historical cost			
1 January 2016 balance	3,318	1,574	4,892
Additions	2,056	178	2,234
Disposals	(2)	(21)	(23)
31 December 2016 balance	5,372	1,731	7,103
Accumulated depreciation			
1 January 2016 balance	(973)	(996)	(1,969)
Depreciation	(593)	(370)	(963)
Of the disposed assets	2	16	18
31 December 2016 balance	(1,564)	(1,350)	(2,914)
Net book value			
31 December 2016 balance	3,808	381	4,189
31 December 2015 balance	2,345	578	2,923

11. Prepayments and accrued income

The following table shows the breakdown of prepayments and accrued income. The receivables are due within a year:

(in €'000)	31.12.2016	31.12.2015
Interest receivable on:		
- Debt securities including fixed-income securities	121,917	217,518
- Loans and advances to euro area Member States	145,291	92,733
- Loans and advances to credit institutions	-	18
Amounts charged to the EFSF for administrative services (Note 20/26)	8,385	5,932
Prepayments	1,238	624
Other*	174,652	1,180
Total prepayments and accrued income	**451,483**	**318,005**

* "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 2016, together with the coupon rates and due dates.

Type of funding/ Programmes	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%
Long-term Funding	EU000A1U9936**	1,000,000	01/03/2016	01/12/2055	1.850%
Long-term Funding	EU000A1U9944	3,000,000	02/03/2016	02/03/2026	0.500%
Long-term Funding	EU000A1U9910**	992,750	11/03/2016	03/11/2020	0.100%
Long-term Funding	EU000A1U9928**	1,000,000	31/03/2016	17/11/2036	1.625%
Long-term Funding	EU000A1U9951	3,000,000	22/04/2016	22/04/2024	0.125%
Long-term Funding	EU000A1U9969	3,000,000	03/05/2016	03/05/2032	1.125%
Long-term Funding	EU000A1U9944**	2,500,000	19/07/2016	02/03/2026	0.500%

Debt securities in issue outstanding on 31 December 2016, together with the coupon rates and due dates – continued from the previous page.

Type of funding/ Programmes	ISIN code	Nominal amount (in €'000)	Issue date	Maturity date	Coupon
Long-term Funding	EU000A1U9977	2,500,000	19/07/2016	18/07/2042	0.875%
Long-term Funding	EU000A1U9951**	961,100	28/07/2016	22/04/2024	0.125%
Long-term Funding	EU000A1U9894**	999,850	29/09/2016	23/09/2025	1.000%
Long-term Funding	EU000A1U9969**	1,000,000	18/10/2016	03/05/2032	1.125%
Long-term Funding	EU000A1U9985*	3,000,000	18/10/2016	18/10/2022	N/A*
Long-term Funding	EU000A1U9951**	989,750	11/11/2016	22/04/2024	0.125%
Long-term Funding	ESMNBOND0001****	80,000	22/01/2016	22/01/2041	1.572%
Long-term Funding	ESMNBOND0002****	30,000	10/02/2016	11/02/2041	1.360%
Long-term Funding	ESMNBOND0003****	25,000	09/03/2016	09/03/2056	1.559%
Long-term Funding	ESMNBOND0004****	25,000	09/03/2016	09/03/2056	1.559%
Long-term Funding	ESMNBOND0005****	25,000	31/03/2016	22/03/2046	1.316%
Long-term Funding	ESMNBOND0006****	30,000	11/04/2016	11/04/2046	1.220%
Long-term Funding	ESMNBOND0007****	40,000	03/08/2016	03/08/2056	1.156%
Long-term Funding	ESMNBOND0008****	150,000	09/08/2016	09/08/2056	1.150%
Long-term Funding	ESMNBOND0009****	50,000	19/08/2016	19/08/2053	1.025%
Long-term Funding	ESMNBOND0010****	50,000	19/08/2016	18/08/2056	1.064%
Long-term Funding	ESMNBOND0011****	50,000	19/09/2016	19/09/2051	1.030%
Long-term Funding	ESMNBOND0012****	50,000	19/10/2016	19/10/2054	1.145%
Long-term Funding	ESMNBOND0013****	40,000	19/10/2016	19/10/2056	1.125%
Long-term Funding	ESMNBOND0014****	25,000	27/10/2016	27/10/2056	1.086%
Short-term Funding	EU000A1Z97L2*	1,498,250	21/07/2016	26/01/2017	N/A*
Short-term Funding	EU000A1Z97N8*	1,492,700	18/08/2016	23/02/2017	N/A*
Short-term Funding	EU000A1Z97Q1*	1,495,800	22/09/2016	23/03/2017	N/A*
Short-term Funding	EU000A1Z97R9*	1,499,250	06/10/2016	12/01/2017	N/A*
Short-term Funding	EU000A1Z97S7*	1,467,300	20/10/2016	20/04/2017	N/A*
Short-term Funding	EU000A1Z97T5*	1,491,200	10/11/2016	09/02/2017	N/A*
Short-term Funding	EU000A1Z97U3*	1,434,000	24/11/2016	18/05/2017	N/A*
Short-term Funding	EU000A1Z97V1*	1,473,200	08/12/2016	09/03/2017	N/A*
Total		**85,358,328**			

* Zero-coupon bond
** Tap issue
*** Floating rate notes issued for disbursements in kind (cashless disbursements)
**** N-bond with technical ISIN: the ESM issued its first N-bond (Namensschuldverschreibungen) in 2016. N-bonds are privately placed, long-term funding instruments that are neither centrally cleared nor listed.

The following table discloses the details of debt securities in issue outstanding on 31 December 2015, together with the coupon rates and due dates.

Type of funding/ Programmes	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 tables show the movements of the debt securities in issue in 2015 and 2016:

(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**

(in €'000)	
1 January 2016 balance	**72,054,845**
Issuance during the period	60,036,718
Maturities during the year	(46,359,700)
Premiums/discounts amortisation	(72,895)
31 December 2016 balance	**85,658,968**

All debt securities in issue on 31 December 2015 and 31 December 2016 are issued under English law as the governing law except for N-bonds, which are issued under German law.

13. Other liabilities

On 31 December 2016, the other liabilities were composed of suppliers' invoices and staff cost related payables which were not yet settled, amounting to €12.1 million (31 December 2015: €9.8 million).

14. Accruals and deferred income

The following table shows the breakdown of the accruals and deferred income:

(in €'000)	31.12.2016	31.12.2015
Interest payable on debts evidenced by certificates	206,759	128,824
Deferred income on up-front service fee	241,075	242,204
Other*	14,897	75,107
Total accruals and deferred income	**462,731**	**446,135**

* "Other" represents the spot revaluation and spread amortisation of ongoing derivative transactions (refer to Note 2.15 and Note 2.5.1).

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 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**

(in €'000)	Subscribed capital	Subscribed, uncalled capital	Subscribed, called capital
1 January 2016	**704,798,700**	**(624,250,300)**	**80,548,400**
Subscription to the authorised capital	-	-	-
Authorised capital calls	-	-	-
31 December 2016	**704,798,700**	**(624,250,300)**	**80,548,400**

On 31 December 2016, 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 2016 Latvia had already made the first three instalments for the payment of paid-in shares in the amount of €132.7 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 2016 Lithuania had made the first two instalments for the payment of paid-in shares in the amount of €130.9 million.

On 31 December 2016, the authorised capital was €704.8 billion (31 December 2015: €704.8 billion), divided into 7,047,987 shares (31 December 2015: 7,047,987 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 2015: €624.3 billion) is callable. On 31 December 2016, the called subscribed capital amounted to €80.5 billion (31 December 2015: €80.5 billion), of which €80.3 billion (31 December 2015: €80.2 billion) is paid.

ESM Members 31 December 2016	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	132,720
Republic of Lithuania	0.4063	28,634	2,863,400	130,880
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**	**80,263,600**

On 31 December 2016, the subscribed capital called but not paid amounted to €0.3 billion and was related to Latvia and Lithuania (31 December 2015: €0.4 billion related to Latvia and Lithuania).

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 macroeconomic 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 16 June 2016, the Board of Governors decided at their annual general meeting to appropriate the net result of 2015 amounting to €729.4 million to the reserve fund. As a result the outstanding balance of the reserve fund on 31 December 2016 is €1.4 billion.

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)	2016	2015
Interest on loans*	644,201	447,113
Amortisation loan premium	(12,633)	(914)
Amortisation up-front service fee	52,629	37,518
Total interest and similar income	**684,197**	**483,717**

* 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.

18. Net interest receivable and similar income on debt securities including fixed-income securities

In view of the current low or negative interest rate environment, securities held as assets in respect of which there is an interest income (taking into account both of interest receivable and amortisation of any premium or discount) are disclosed separately from those in respect of which there is an interest expense. In 2016, interest receivable and similar income on debt securities including fixed income securities amounted to €77.2 million (2015: €138.3 million*). The expense arising from the negative yield on some of these securities of €3.7 million (2015: €0.7 million*) is disclosed as interest payable and similar charges on debt securities including fixed income securities.

The net interest receivable and similar income on debt securities including fixed-income securities was therefore €73.5 million (2015: €137.6 million) and the geographical breakdown is detailed as follows:

(in €'000)	2016	2015
Euro area issuers	28,683	65,969
Other EU issuers	10,817	10,844
EU supranational organisations	13,727	39,308
Total European Union	**53,227**	**116,121**
Other non-EU issuers	11,906	11,240
Other supranational organisations	8,358	10,277
Total outside the European Union	**20,264**	**21,517**
Total interest and similar income	**73,491**	**137,638**

* The figures for the year end 2015 relating to net interest receivable on debt securities including fixed income have been reclassified to ensure comparability with the figures of the year ended 2016.

19. Net interest payable and similar charges on debt securities in issue

In view of the current low or negative interest rate environment, securities issued by the ESM (liabilities) in respect of which there is an interest expense (taking into account both of interest payable and amortisation of any premium or discount) are disclosed separately from those in respect of which there is an interest income. In 2016, interest payable and similar charges on debts issued was €525.9 million (2015: €333.7 million*). The income amount arising from the negative yield on some debt issued by the ESM was €76.2 million (2015: €26.0 million*) and is disclosed as interest receivable and similar income on debts issued. The net expenditure on debt issued was therefore €449.7 million (2015: €307.7 million).

* The figures for the year end 2015 relating to net interest payable on debt securities in issue have been reclassified to ensure comparability with the figures of the year ended 2016.

20. 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 2016, the ESM charged the EFSF €26.7 million (2015: €24.6 million), from which € 8.4 million had yet to be paid on the balance sheet date (refer to Note 11).

21. Net profit on financial operations

Net profit on financial operations is detailed as follows:

(in €'000)	2016	2015
Net realised result of sales of debt securities	287,073	438,777
Total net result on financial operations	**287,073**	**438,777**

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.

22. Staff costs

Staff costs are detailed as follows:

(in €'000)	2016	2015
Salaries and allowances*	20,213	16,670
Social security costs	1,034	884
Pension costs	6,084	4,899
Total staff costs	**27,331**	**22,453**

* Of which €1.6 million (2015: €1.4 million) relate to the ESM Management Board members, including €0.35 million (2015: €0.34 million) to the ESM Managing Director.

The ESM employed 164 people on 31 December 2016 (145 on 31 December 2015), along with trainees on a short-term basis.

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 €0.8 million for the 2016 financial year (2015: €1.1 million) and are accounted for as 'Other administrative expenses' (refer to Note 23).

23. Other administrative expenses

Other administrative expenses consist of fees paid for professional services and miscellaneous operating expenses and are detailed as follows:

(in €'000)	2016	2015
Outsourced services (mainly IT, HR and accounting services)	8,362	6,583
Treasury related services	880	2,151
Advisory services	4,492	6,349
Rental and related services	2,877	2,937
IT Hardware	2,581	2,253
Interim and secondment fees (Note 22)	817	1,094
Legal services	1,045	1,217
Rating agencies fees	488	504
Other services	4,204	3,578
Total other administrative expenses	**25,746**	**26,666**

24. Off-balance commitments

The off-balance sheet commitments represent the undisbursed part of the financial assistance programmes and are detailed as follows:

(in €'000)	2016	2015
Financial assistance programme to Cyprus	-	2,668,000
Financial assistance programme to Greece	54,274,000	64,597,572
Total undisbursed amounts	**54,274,000**	**67,265,572**

Any further disbursement is subject to conditionality in line with the Memorandum of Understanding attached to the Financial Assistance Facility Agreement.

25. Derivatives

The ESM uses derivatives for risk management purposes only. 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.

The following table discloses the details of derivatives outstanding as at 31 December 2016, together with their fair value.

(in €'000)	Notional Amounts (receivable)	Notional Amounts (payable)	Fair Value
Currency swaps	900,997	(741,301)	159,696
Currency forwards	2,356	(2,227)	129
Total	**903,353**	**(743,528)**	**159,825**

The following table discloses the details of derivatives outstanding on 31 December 2015, together with their fair value.

(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 2016 and 2015, all derivative financial instruments had a final maturity of maximum two years (one year for 2015) and all of them were concluded with a euro area central bank or with the Bank of International Settlements.

25.1. 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 and an amount of €4.2 million recorded in 'Interest receivable and similar income' (2015 €1.3 million), as well as €3.2 million in 'Interest payable and similar charges' (2015 €0.6 million).

26. 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 any 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 macroeconomic 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.

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 €26.7 million (refer to Note 20) for the financial year 2016 (2015: €24.6 million), from which €8.4 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.

27. Audit fee

The total fees accrued are presented as follows:

(in €'000)	2016	2015
Audit fees	243	243
Total Audit fees	**243**	**243**

The external auditor did not provide the ESM with non-audit services.

28. Events after the reporting period

Following the Eurogroup agreement of 24 May 2016, a set of short-term debt relief measures for Greece was endorsed by euro area finance ministers at the Eurogroup meeting on 5 December 2016 and approved by the ESM Board of Governors in a written procedure concluded on 20 January 2017. The Board of Directors of the ESM adopted it on 23 January 2017.

These measure are composed of three schemes aimed at reducing interest rate risk for Greece. The first is a bond exchange, where floating rate notes disbursed by the ESM to Greece for bank recapitalisation will be exchanged for fixed coupon notes. The second scheme allows the ESM to enter into swap arrangements to reduce the risk that Greece will have to pay a higher interest rate on its loans when market rates start rising. The third scheme is known as "matched funding", which will entail issuing long-term bonds that closely match the maturity of the Greek loans, and implies the ESM charging a fixed rate on part of future disbursements to Greece.

This debt relief carries no budgetary implications for ESM Member States and has no impact on the 2016 financial statements.

05 EXTERNAL AUDITOR'S REPORT ON THE 2016 FINANCIAL STATEMENTS

TO THE BOARD OF GOVERNORS OF THE EUROPEAN STABILITY MECHANISM

Luxembourg, 30 March 2017

We have audited the accompanying financial statements of European Stability Mechanism, which comprise the balance sheet as at date 31 December 2016, and 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 financial statements 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 2016, 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 2016 FINANCIAL STATEMENTS

Luxembourg, 30 March 2017

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[35].

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 2016.

In 2015 the ESM completed the development of its internal control framework (ICF). This allowed the ESM Management to assert that during 2016, the first full year of operation of this framework, the ESM maintained effective internal controls. The oversight of the internal control framework on an ongoing basis will be taken into account by the Board of Auditors in its work programme.

The Board of Auditors notes that, to the best of its judgment, no 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 2016.

On behalf of the Board of Auditors

Kevin Cardiff
Chairperson

[35] 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 2016 will be included in the annual report, to be prepared in accordance with Article 24(6) of the ESM By-Laws and submitted to the Board of Governors.

ACRONYMS AND ABBREVIATIONS

ALM	Asset and Liability Management
BoD	Board of Directors
BoG	Board of Governors
Bps	Basis points
DRI	Direct Recapitalisation Instrument
ECB	European Central Bank
EDP	Excessive Deficit Procedure
EFSF	European Financial Stability Facility
ESM	European Stability Mechanism
GDP	Gross domestic product
GFN	Gross financing needs
IFI	International financial institution
IMF	International Monetary Fund
NEER	Nominal effective exchange rate
NPL	Non-performing loan
NPV	Net present value
PSPP	Public-sector purchase programme
SFP	Stock-flow pressure
SSA	Supranational, sub-sovereign, and agency (bond issuers)

EURO AREA

COUNTRY CODE	COUNTRY NAME
BE	Belgium
DE	Germany
EE	Estonia
IE	Ireland
EL	Greece
ES	Spain
FR	France
IT	Italy
CY	Cyprus
LV	Latvia
LT	Lithuania
LU	Luxembourg
MT	Malta
NL	Netherlands
AT	Austria
PT	Portugal
SI	Slovenia
SK	Slovakia
FI	Finland

NON-EURO AREA

COUNTRY CODE	COUNTRY NAME
JP	Japan
UK	United Kingdom
US	United States

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