

Frequently Asked Questions on the European Stability Mechanism (ESM)

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FAQ on the EFSF are available at http://www.efsf.europa.eu/attachments/faq_en.pdf

Section A – General questions about the ESM

➤ **A1 – What is the European Stability Mechanism (ESM)?**

The ESM is the permanent crisis resolution mechanism for the countries of the euro area. Its purpose is to provide stability support through a number of financial assistance instruments to ESM Member States which are experiencing, or are threatened by severe financing problems. For this purpose, the ESM is entitled to raise funds by issuing financial instruments or by entering into financial or other agreements with ESM Members, financial institutions or other third parties.

The ESM may provide stability support by:

- providing loans to countries in financial difficulties,
- purchasing bonds of an ESM Member State in primary and secondary debt markets,
- providing precautionary financial assistance in the form of a credit line,
- financing recapitalisations of financial institutions through loans to governments including in non-programme countries.

All financial assistance to Member States is linked to appropriate conditionality.

The ESM will use an appropriate funding strategy so as to ensure access to broad funding sources and

This FAQ has not been updated since July 2014; up-to-date information on the ESM is available at <https://www.esm.europa.eu/explainers>

enable it to extend financial assistance packages to Member States under all market conditions.

➤ **A2 – What is the legal basis of the ESM and how was it established?**

The Treaty Establishing the ESM was originally signed by finance ministers of the 17 euro area countries on 11 July 2011. However, a modified version of the Treaty, incorporating amendments aimed at improving the effectiveness of the mechanism, was signed in Brussels on 2 February 2012.

The ESM Treaty entered into force on 27 September 2012 and the European Stability Mechanism was inaugurated on 8 October 2012 following ratification by all (then) 17 euro area Member States. An amended version of the Treaty upon the accession of Latvia to the ESM entered into force on 13 March 2014.

➤ **A3 - What is the legal form of the ESM?**

The ESM is established as an intergovernmental organisation under public international law.

➤ **A4 – Where is the ESM headquartered?**

The ESM's office is in Luxembourg.

➤ **A5 – Who governs the ESM? How are decisions taken?**

The ESM has a Board of Governors consisting of the Ministers of Finance of the euro area Member States (as voting members), while the European Commissioner for Economic and Monetary Affairs and the ECB President may participate as observers.

The most important decisions taken by the Board of Governors require mutual consent (unanimity). These include decisions to provide stability support to an ESM Member, the choice of instruments, conditions and terms of such support, calling in authorised unpaid capital (with the exception of emergency capital calls), changing the authorised capital stock and adapting the maximum lending volume.

In a number of areas the Board of Governors take decisions by qualified majority (defined in the ESM Treaty as 80% of the votes cast, with voting rights equal to the number of shares allocated to each country). These areas include setting out the detailed terms of accession of a new member to the ESM, appointing the Managing Director, and approving the annual accounts of the ESM.¹

The ESM also has a Board of Directors. Each euro area country appoints one Director and one alternate Director from among people of high competence in economic and financial matters. As in the case of the Board of Governors, the European Commission and ECB may appoint a non-voting observer. The Board of Governors may delegate to the Board of Directors one or more tasks entrusted to the former by the ESM Treaty. As a rule, decisions of the Board of Directors are taken by qualified majority, however, it may not take any action pursuant to such delegation which is inconsistent with any action taken by the Board of Governors.

The Board of Governors appoints a Managing Director responsible for the day-to-day management of the ESM. The Managing Director chairs the Board of Directors, as well as the Management Board, which assists the Managing Director in conducting the current business of the ESM. The term of office of the Managing Director is 5 years. He/she may be reappointed once. While holding office, the Managing Director may not be a Governor, Director or an alternate of either.

➤ **A6 – How does the ESM's emergency voting procedure work?**

¹ A full list of issues decided by mutual consent and QMV by the Board of Governors can be found in Article 5 of the ESM Treaty.

The ESM Treaty includes an emergency voting procedure, whereby financial assistance can be granted if supported by a qualified majority of 85% of the votes cast. When this procedure is used, a provision from the reserve fund and/or the paid-in capital to an emergency reserve fund is made in order to cover the risks arising from the financial support granted under this procedure.

➤ **A7 - What is the ESM's lending capacity?**

The ESM's maximum lending capacity is €500 billion. During the Eurogroup meeting held on 30 March 2012, it was decided that the EFSF would continue to fund the existing Facility Agreements for Portugal, Ireland and Greece.

➤ **A8 – Can the European Financial Stability Facility (EFSF) engage in new financial assistance programmes?**

No. As of 1 July 2013 the ESM is the only instrument to finance new programmes. The EFSF will continue to finance programmes that started before the ESM Treaty was signed (*see question B3*).

➤ **A9 – How is the ESM's capital structured?**

The ESM has a total subscribed capital of nearly €702 billion. This includes €80 billion in the form of paid-in capital provided by the euro area Member States in five instalments of €16 billion. The payment of paid-in capital was completed by the 17 original ESM Members in April 2014. Latvia, which joined the ESM in March 2014, has paid its initial instalment of paid-in capital and will complete payments in 2018.

In addition, the ESM's capital comprises committed callable capital from euro area Member States to a total amount of approximately €622 billion.

➤ **A10 – When can capital calls be made?**

There are three different instances when a capital call can be made:

- 1) General capital calls
- 2) Capital calls to replenish paid-in capital
- 3) Emergency capital calls

1) A general capital call concerns payment of the initial capital and an increase of paid-in capital which 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, with mutual agreement, may call in authorized capital at any time.

2) A capital call to replenish paid-in capital could happen for two reasons: a) to cover any losses in paid-in capital due to a non-payment by a beneficiary country and b) in order to maintain a minimum 15% ratio between paid-in capital and the lending capacity of ESM. The Managing Director would again make a proposal, this time to the Board of Directors, which would specify the losses incurred and the underlying reasons. Simple majority of the Board of Directors is required to agree to call in capital under these circumstances.

If any ESM member fails to meet the required capital call, one or more revised increased capital calls would be made to all ESM Members by increasing the contribution rate of the remaining ESM Members on a pro-rata basis. When the ESM Member which failed to contribute settles its debt to the ESM, the excess capital is returned to the other ESM Members.

3) Finally, an emergency capital call would be used to avoid default of an ESM payment obligation to

its creditors. The Managing Director would have the responsibility to make such a capital call to ESM shareholders if there were such 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 7 days of receipt of the demand. However, if any ESM Member fails to meet the required capital call, the same procedure would apply as for capital calls to replenish paid-in capital. This mechanism works effectively like a guarantee and provides the strongest possible assurance to ESM bondholders that they will always be serviced and repaid.

- **A11 – Does the ruling of the German Constitutional Court of 12 September 2012 have an effect on the way the capital calls work?**

No, the ruling of the German Constitutional Court does not change anything for Germany with respect to capital calls. All Member States share this interpretation of the Court's ruling.

The particular payment obligations of each future ESM member resulting from the capital calls mentioned above are limited to the amounts stipulated in Annex II to the ESM Treaty. In the case of Germany, for instance, any liability is capped at €190 billion, unless ESM Members unanimously agree to change the amount of subscribed capital.

- **A12 – Will the ESM be able to use the paid-in capital to purchase sovereign bonds in the market?**

The paid-in capital is invested in high quality liquid assets and in accordance with ESM investment guidelines. It will serve as loss absorbing capital only. Thus the paid-in capital will not be used to purchase sovereign bonds under an ESM primary or secondary market intervention, but it could be used to purchase top-rated and liquid sovereign bonds for investment purposes.

- **A13 - What is the ESM's shareholder contribution key?**

The ESM shareholder contribution key is based on the ECB contribution key.² Member States with a GDP per capita of less than 75% of the EU average will benefit from a temporary correction for a period of 12 years after their entry in the euro area.

As a consequence of the accession of Latvia to the ESM, the shareholder contribution keys of the 17 founding Members of the ESM are now slightly lower, but their nominal capital subscription and amount of paid-in capital remain the same.

ESM Member	Key 2012 (%)	Key 2014 (%)	Capital subscription (€ bn)	Paid-in capital (€ bn)
Austria	2.7834	2.7757	19.48	2.23
Belgium	3.4771	3.4675	24.34	2.78
Cyprus	0.1962	0.1957	1.37	0.16
Estonia	0.1860	0.1855	1.30	0.15
Finland	1.7974	1.7924	12.58	1.44
France	20.3859	20.3297	142.70	16.31

² The ECB contribution key is calculated to reflect the respective country's share in the total population and gross domestic product of the EU. These two determinants have equal weighting.

Germany	27.1464	27.0716	190.02	21.72
Greece	2.8167	2.8089	19.72	2.25
Ireland	1.5922	1.5878	11.14	1.27
Italy	17.9137	17.8643	125.40	14.33
Latvia*	--	0.2757	1.93	0.22
Luxembourg	0.2504	0.2497	1.75	0.20
Malta	0.0731	0.0729	0.51	0.06
Netherlands	5.7170	5.7012	40.02	4.57
Portugal	2.5092	2.5023	17.56	2.01
Slovakia	0.8240	0.8217	5.77	0.66
Slovenia	0.4276	0.4264	2.99	0.34
Spain	11.9037	11.8709	83.33	9.52
Total	100	100	701.94	80.22

*Latvia will provide its share of paid-in capital in five annual instalments from 2014 to 2018

➤ **A14 – When did Latvia become a Member of the ESM?**

After joining the euro area on 1 January 2014, Latvia became the 18th Member of the ESM on 13 March 2014.

For more information, please consult the [FAQ on the accession of Latvia to the ESM](#).

➤ **A15 – Did Latvia also become a Member of the EFSF?**

No. Since 1 July 2013 the EFSF may no longer engage in new financing programmes or enter into new loan facility agreements, and there was no obligation for Latvia to join the EFSF. Latvia will thus not be a guarantor of bonds issued by the EFSF.

➤ **A16 – What is the reserve fund?**

The net income generated by the ESM operations, as well as 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 TFEU will be put aside in a reserve fund. The resources of the reserve fund will be invested in accordance with guidelines adopted by the ESM's Board of Directors.

➤ **A17 – How would losses arising from ESM operations be charged?**

If such losses occur, they will be charged firstly against the reserve fund, secondly against the paid-in

capital and lastly against an appropriate amount of authorised unpaid capital.

➤ [A18 – How is the ESM rated?](#)

The ESM has been assigned the highest long-term rating by Fitch (AAA). Moody's has assigned the ESM an AA1 rating. Both Fitch and Moody's have assigned their highest short-term ratings to the ESM (F1+, P-1, respectively).

➤ [A19 – Does the IMF cooperate with the ESM?](#)

The ESM cooperates very closely with the IMF in providing stability support. Wherever possible, a participation of the IMF will be sought on a technical and financial level. A euro area Member State requesting financial assistance from the ESM is expected to address, wherever possible, a similar request to the IMF.

➤ [A20 – Do ESM loans have preferred creditor status?](#)

It is the mutual understanding of ESM members that ESM loans under a macroeconomic adjustment programme and recapitalisation facilities will enjoy preferred creditor status in a similar fashion to those of the IMF, while accepting preferred creditor status of the IMF over the ESM. This would, however, not apply to ESM financial assistance in the form of ESM loans following a European financial assistance programme existing at the time of the signature of the ESM Treaty.

The decision to forego preferred creditor status in the case of the recapitalisation of Spanish banks was one-off in nature, as the Financial Assistance Facility Agreement (FFA) was negotiated by the EFSF. This FFA will be transferred to the ESM with rights and obligations, including the EFSF's pari passu status.

➤ [A21 – Would it be possible to make changes to the ESM's seniority status without amending the ESM treaty?](#)

Seniority for ESM loans is a mutual understanding between ESM members and is mentioned in recital (13) of the ESM treaty. Reference is made to the decision of Heads of State and Government in that regard. A repeal or amendment of their earlier statement would therefore also require a decision by the Heads of State or Government. In several Member States it would require support by the national parliament.

➤ [A22 – Would it be necessary to amend the ESM Treaty for the ESM to directly recapitalise banks?](#)

Based on Article 19 of the ESM Treaty it would be possible without a treaty change, by a unanimous decision of the Board of Governors.

➤ [A23 – Can non-euro area Member States contribute to financial assistance provided to ESM Members?](#)

Non-euro area Member States may participate on an ad hoc basis alongside the ESM in financial assistance operations for euro area Member States.

➤ [A24 – What is the procedure for granting stability support by the ESM?](#)

Financial assistance from the ESM will in all cases be activated upon a request from a Member State to the Chairperson of the ESM's Board of Governors.

If ESM Stability Support is requested, the Commission in liaison with the ECB will assess the existence of a risk to the financial stability of the euro area as a whole. It will also assess whether public debt is sustainable. Wherever appropriate and possible, such an assessment is expected to be conducted together with the IMF. It will also assess the actual financing needs of the Member State concerned.

Based on this assessment, the Commission will negotiate in liaison with the ECB, and wherever possible, together with the IMF, a Memorandum of Understanding (MoU) detailing the conditionality attached to the financial assistance facility. The Commission will sign the MoU on behalf of the ESM.

The Managing Director of the ESM will make a proposal for financial assistance, the instrument and its terms and conditions to the Board of Governors. When the Board of Governors has adopted the overall financial support and its main terms, the Board of Directors will then approve the financial assistance facility agreement detailing the technical aspects of the assistance.

The Commission, in liaison with the ECB and, wherever possible, together with the IMF, will be responsible for monitoring compliance with the conditionality attached to the financial assistance facility.

➤ **A25 – Is there a link with the “fiscal compact”?**

Following agreement reached at the European Council on 30 January 2012 on the fiscal compact, the ESM treaty now stipulates that the granting of financial assistance will be conditional, as of 1 March 2013, on the ratification of the fiscal compact by the ESM member state concerned.

➤ **A26 - Will ESM liabilities increase the government debt of the shareholder countries?**

No. According to a preliminary note published by Eurostat,³ the ESM will be treated in the same way as similar international financial organisations such as the IMF. Loans from the ESM to a euro area country in need will be recorded in the same way as a loan from the IMF to a Member State (i.e. as a direct loan from an international organisation to the country in question). Therefore, unlike the loans provided by the EFSF, the loans provided by the ESM will not be rerouted through the accounts of other euro area countries and will therefore not increase their government debt.

➤ **A27 – Are the ESM's accounts subject to external audit?**

Yes, the accounts of the ESM will be audited by independent external auditors, who will have the power to examine all books and accounts and obtain full information about the ESM's transactions.

In addition the ESM will have a Board of Auditors consisting of five members appointed by the Board of Governors. It will include two members from the supreme audit institutions of the ESM Members - with a rotation between the latter - and one from the European Court of Auditors.

➤ **A28 – Is there a procedure for settling disputes?**

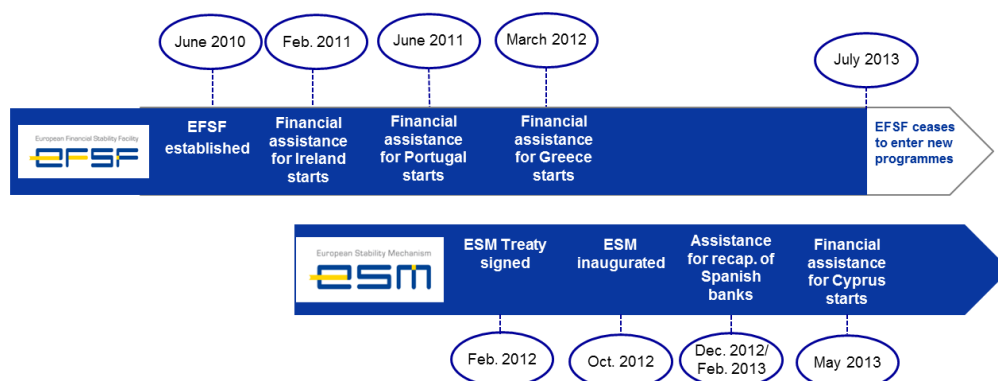
Yes, the Board of Governors will decide on any dispute arising between an ESM Member and the ESM, or between ESM Members, in connection with the interpretation and application of the ESM Treaty. If an ESM Member contests such a decision taken by the Board of Governors, the dispute will be submitted to the Court of Justice of the European Union.

➤ **A29 – Do you intend to ask for a banking license for the ESM?**

No. The ECB published an analysis last year, stating that legal reasons prevent the ESM from becoming a counterparty of the Eurosystem, which holds similar for the EFSF. It should be pointed out that the question of a banking license is often over-interpreted. It would make funding easier, but would not allow unlimited lending by the EFSF or ESM.

³<http://www.cmfb.org/pdf/2011-04-07%20Eurostat%20preliminary%20view%20on%20the%20recording%20of%20the%20European%20Stability%20Mechanism.pdf>

Section B – ESM and EFSF working together



Timeline of EFSF and ESM establishment and financial assistance

➤ B1 – Will the ESM and EFSF be parallel in the market?

Yes. Both institutions will issue bonds in parallel. Moreover, EFSF and ESM issuance are managed by the same team, ensuring full coordination between the two entities but working on the basis of two separate balance sheets.

➤ B2 – Do the ESM and EFSF share the same staff?

Yes, existing EFSF staff perform their respective tasks for the ESM. The current number of employees is approximately 130.

➤ B3 – What is the current status of the EFSF?

As of 1 July 2013, the EFSF may no longer engage in new financing programmes or enter into new loan facility agreements. This is in accordance with the EFSF Framework Agreement signed by the (then) 17 euro area Member States, and the EFSF Articles of Incorporation. From that date, the European Stability Mechanism is the sole and permanent mechanism for responding to new requests for financial assistance by euro area Member States.

The EFSF will remain active in financing the ongoing programme Greece. Even though EFSF financial assistance will soon have been completed, it is still necessary for the EFSF to roll over bonds issued to finance the loans for the 3 EFSF programme countries.

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.

➤ B4 – Will the ESM and EFSF be merged?

The EFSF is a company established under Luxembourg law whereas the ESM is an intergovernmental institution established under international law. As legal entities with such different structures, the two institutions will not be merged.

However, the current staff of the EFSF also work for the ESM. This will allow the ESM to benefit from the experience gained since the launch of the EFSF in 2010. Over the last two years, the EFSF has become a well-established issuer in the sovereign debt market. We fully expect to continue this success with the ESM.

- B5 – Assuming that Portugal or Greece needs further support beyond the scheduled €192bn, will the EFSF provide financial assistance? Or will the ESM take care of that additional financing?

If one of these countries were to need further support, a new programme and a new Memorandum of Understanding would be necessary. Granting such a programme would require a decision at political level. It would not be undertaken by the EFSF, which will not be able to initiate new programmes after 30 June 2013. Any new financial assistance programme would thus be carried out by the ESM.

- B6 – Can EFSF support commitments be transferred to the ESM?

Yes, the Board of Governors of the ESM may decide that the EFSF commitments to provide financial assistance will be assumed by the ESM, in particular as far as such commitments relate to undisbursed and unfunded parts of loan facilities.

- B7 – There is a theoretical possibility that the ESM would take over EFSF bonds in the ESM Treaty. Will this happen? What would be the process?

No, this is not currently envisaged.

For more information on the EFSF, please consult the Frequently Asked Questions on the EFSF:

http://www.efsf.europa.eu/attachments/fag_en.pdf

Section C – Funding ⁴

- C1 – Does the ESM do its own funding?

Yes. The ESM is empowered to borrow on capital markets from banks, financial institutions or other persons or institutions for the performance of its purpose. Issues may be made via syndications, auctions, private placements and new lines. The ESM is the issuer of all debt instruments, which fall into the category of SSA (Sovereign, Supranational, Agency) issuance.

- C2 – What are the ESM's funding objectives and principles?

In order to effectively perform its purpose of providing stability support to euro area countries, the ESM pursues the following objectives with respect to funding: (i) the ESM must be able to react quickly to unexpected market developments and to that end it will build up liquidity buffers during periods of heightened systemic risk to ensure market access even in a difficult market conditions; (ii) the ESM must be capable of raising predictable amounts over an extended period of time covering various disbursement schedules, as well as unexpected amounts on relatively short notice; (iii) to achieve the aim of establishing itself as a reliable issuer in a difficult market environment, the ESM's funding portfolio will comprise liquid instruments with a simple, plain vanilla structure.

- C3 – What is the ESM's funding strategy?

The ESM applies a diversified funding strategy, which entails the use of a variety of instruments and maturities to ensure the efficiency of funding and continuous market access. One feature of this strategy

⁴ See ESM Borrowing Guidelines, <http://www.esm.europa.eu/pdf/ESM%20borrowing%20guidelines.pdf>

is that funds raised through various instruments are not attributed to a particular country. The funds are pooled and then disbursed to programme countries. The ESM applies two such pools: a short-term and medium-to-long-term funding pool.

➤ C4 – What funding tools does the ESM apply?

The ESM applies capital market and money market instruments. Capital market tools include benchmark bonds issued with maturities ranging from 1 to 30 years. The ESM may hold its own bonds for a limited amount, so that additional funding may be raised by selling the bonds on the secondary market or by using them as collateral in the secured money market. As a supplement to the bond programme, the ESM may issue promissory/registered notes.

The ESM issues bills through regular auctions and may also engage in unsecured money market transactions. Transactions may be conducted overnight, on a rolling basis or for tenors up to one year. The ESM may also issue commercial paper, money market promissory notes and engage in repo transactions. In addition, the ESM has established liquidity lines with the DMOs of ESM members and a network of credit lines with private banks.

➤ C5 – Why have the initial ESM bonds been trading tighter than EFSF?

Thanks to the stronger and more transparent capital structure (paid-in capital) of the ESM, it was able to obtain more favourable funding costs compared to the EFSF.

➤ C6 – What is the risk weighting for securities issued by the ESM?

The Basel Committee on Banking Supervision announced on 18 March 2014 that securities issued by the ESM and EFSF are to be designated as high quality liquid assets. As a result, ESM and EFSF securities have been assigned a 0% risk weighting under the Basel II Standardised Approach for Credit Risk.

The 0% risk weighting for ESM and EFSF securities is also stated in the Capital Requirements Regulation (CRR)⁵, which together with the Capital Requirements Directive implement the Basel Committee's recommendations into EU law.

➤ C7 – Will the ESM be able to participate in the repo market to finance bond purchases?

No, with regard to the ECB's repo operations. Yes, with private banks or other market participants.

➤ C8 – Can we expect the ESM to provide partial risk protection certificates or co-investment funds in the near future? Or is it only a theoretical option, which will not be used?

ESM Member States are considering extending to the ESM the options introduced last year to maximise the capacity of the EFSF: the partial protection certificates and the co-investment funds. These options could be used to support market access for countries within a full or precautionary programme.

Technical work is under way and will be considered in due course by the ESM governing bodies.

➤ C9 – Which banks may be appointed as lead managers?

The lead managers will be mandated from the 44 international institutions that make up the ESM Market

⁵ Regulation (EU) no 575/2013 of the European Parliament and the Council, Article 118.

Group.⁶ The lead managers are chosen following a rigorous and transparent selection process.

➤ C10 – Who are the main investors in ESM bonds?

As with the EFSF, investors in ESM bonds are predominantly institutional investors such as banks, pension funds, central banks, sovereign wealth funds, asset managers, insurance companies and private banks.

➤ C11 – Does the ESM issue in euros only?

The ESM will initially focus on establishing a curve of benchmarks denominated in euros. The ESM may then further diversify its funding strategy by issuing in currencies other than the euro. Such foreign currency issues would be hedged through swap contracts.

Section D – Stability support loans within a macro-economic adjustment programme ⁷

➤ D1 - What is the objective of ESM stability support loans?

The objective is to assist ESM Members that have significant financing needs but have to a large extent lost access to market financing, whether because they cannot find lenders or because lenders will provide financing only at excessive prices that would adversely impact the sustainability of public finances.

➤ D2 - What is the procedure for granting a stability support loan?

An ESM Member may address a request for stability support to the Chairperson of the ESM Board of Governors. In such case, the European Commission in liaison with the ECB and wherever possible, together with the IMF, will assess the financing needs of the ESM Member concerned and whether its public debt is sustainable. Based on this assessment, the Managing Director will prepare a proposal for adoption by the Board of Governors whether to grant a stability support loan to the ESM Member. If such a decision is taken, the European Commission in liaison with the ECB, and wherever possible, together with the IMF, will negotiate with the ESM Member concerned a Memorandum of Understanding (MoU) detailing the conditionality of the financial assistance facility. In parallel, the Managing Director of the ESM will prepare a financial assistance facility agreement (FFA).

The European Commission will sign the MoU on behalf of the ESM, subject to approval by the Board of Governors. The Board of Directors will then approve the FFA and, where applicable, the disbursement of the first tranche of assistance.

➤ D3 – How will the loans be disbursed?

Loans will be provided in one or more tranches, which may each consist of one or more disbursements. The disbursement of the first tranche will be decided by the Board of Directors together with the approval of the financial assistance facility agreement.

A decision regarding the disbursement of subsequent tranches of financial assistance will be taken by the Board of Directors on a proposal from the Managing Director, and after having received a report from the European Commission on the monitoring of and compliance by the beneficiary ESM Member with the policy conditionality attached to the FFA.

⁶ For a list of institutions comprising the ESM Market Group, see

<http://www.esm.europa.eu/pdf/ESM%20Market%20Group1.pdf>

⁷ See ESM Guideline on Loans, <http://www.esm.europa.eu/pdf/ESM%20Guideline%20on%20loans.pdf>

➤ D4 - How fast can the ESM provide financial support?

Following a request from a euro area Member State for financial assistance, as a rule it takes three to four weeks to draw up a support programme including sending experts from the Commission, the IMF and the ECB to the country in difficulty. Once euro area finance ministers have approved the country programme, the ESM would need several working days to raise the necessary funds and disburse the loan.

➤ D5 – What kind of conditions may be linked to ESM support?

Any financial assistance to a country in need is linked to policy conditions which are set out in the (MoU) between the country in need and the European Commission. For example, conditions for the EFSF Irish programme included strengthening and overhaul of the banking sector, fiscal adjustment including correction of excessive deficit by 2015 and growth enhancing reforms, in particular of the labour market.

➤ D6 – Who will monitor compliance with the policy conditionality associated with the financial support?

The European Commission, in liaison with the ECB, and wherever possible, the IMF, will be entrusted with the monitoring. The beneficiary ESM Member will be obliged to provide to these institutions all the information that is deemed necessary for the monitoring of the policy conditionality of the programme as agreed in the MoU. The beneficiary state will also provide the ESM all information necessary to conduct its financial due diligence.

➤ D7 - What happens if a beneficiary country fails to meet the conditions?

If monitoring processes highlight significant deviations from the macroeconomic adjustment programme, the Board of Governors may consider that the beneficiary ESM Member does not comply with the policy requirements specified in the programme. In such case, disbursements of a tranche will stop until the Board of Governors decides to re-authorise them.

➤ D8 - What is the maturity of ESM loans?

The ESM Treaty does not specify any maturity limitations for the loans. They will be defined on a case-by-case basis.

➤ D9 - What will be the cost of a stability support loan provided to ESM Members⁸ ?

The total cost of a loan is an aggregate of several distinct elements:

- 1) Base rate – the cost of funding and operations incurred by the ESM, derived by a daily computation of the actual interests accrued on all of the bonds, bills and other funding instruments issued by the ESM.
- 2) Commitment fee – the negative cost of carry⁹ and issuance costs, charged for the period from raising funds by the ESM until disbursement to the Beneficiary Member State or for the period from the refinancing of relevant funding instrument until its maturity. The commitment fee will be applied ex-post on the basis of the negative carry actually incurred.
- 3) Service fee – the source of general revenues and resources to cover the ESM's operational costs. The service fee has two components: (i) up-front service fee (50 bps) deducted from the drawn amount, (ii) annual service fee (0.5 bp) paid on the interest payment date.
- 4) Margin – paid on interest payment date. The margin charged differs across financial support

⁸ For more detailed information concerning the pricing of ESM stability support instruments, please consult “ESM Pricing Policy”: <http://www.esm.europa.eu/pdf/Pricing%20guideline.pdf>

⁹ Negative cost of carry reflects the fact that the interest rate at which ESM raises funds would most likely be higher than the return obtained for shorter-term investments in high quality assets

instruments to reflect varying risk profiles of each instrument. In the case of loans, the margin will be 10 bps.

A penalty interest may be applied on overdue amounts.

➤ **D10 - Does the ESM support countries outside the euro area?**

No. For Member States outside the euro area, other European Union support mechanisms exist, such as the Balance of Payments facility;¹⁰ while for countries outside the EU there is the Macro-Financial Assistance programme.¹¹

Section E – ESM support instruments

Bank recapitalisations¹²

➤ **E1 – What is the objective of ESM’s financial assistance to for the recapitalisation of financial institutions?¹³**

The aim of a loan for recapitalising financial institutions is to preserve financial stability of the euro area as a whole and of its Member States by addressing those specific cases in which the roots of a crisis situation are primarily located in the financial sector and not directly related to fiscal or structural policies. Such assistance will thus be provided in order to limit the contagion of financial stress by ensuring the capacity of a beneficiary ESM Member’s government to finance recapitalisation at sustainable borrowing costs and facilitate financial sector repair so that vulnerabilities are eliminated.

➤ **E2 – What are the eligibility criteria for obtaining this type of support?**

The beneficiary should demonstrate the existence of a lack of alternatives for recapitalising the financial institution(s) concerned: this should first reveal an inability to meet capital shortfalls via private sector solutions (e.g. tapping new market investors or existing shareholders¹⁴) and, second, an inability of the beneficiary ESM Member to recapitalise the institution(s) without incurring very adverse effects on its own financial stability and fiscal sustainability.

In addition, the financial institution(s) concerned should be of systemic relevance or pose a serious threat to the financial stability of the euro area as a whole or of its Member States.¹⁵ Their systemic dimension will be assessed taking into account, primarily, their size, interconnectedness, complexity, and substitutability.

Finally, the beneficiary ESM Member should also demonstrate its ability to reimburse the loan granted, even in cases in which it would not be able to recover the capital injected in the beneficiary institution(s) according to the timing agreed in relevant state-aid decisions. The beneficiary shall also demonstrate the existence of a sound fiscal and macroeconomic policy record.

¹⁰ See http://ec.europa.eu/economy_finance/eu_borrower/balance_of_payments/index_en.htm

¹¹ See http://ec.europa.eu/economy_finance/eu_borrower/macro-financial_assistance/index_en.htm

¹² See ESM Guideline on Financial Assistance for the Recapitalisation of Financial Institutions, <http://www.esm.europa.eu/pdf/ESM%20Guideline%20on%20recapitalisation%20of%20financial%20institutions.pdf>

¹³ Currently the ESM may provide indirect assistance for bank recapitalisation, i.e. loans to ESM Member States for the purpose of bank recapitalisation.

¹⁴ Where a legal framework permits, such private sector solutions could also include the writing-down or conversion of debt in order to facilitate recapitalisation and a return to viability.

¹⁵ According to the guideline on the recapitalisation of financial institutions, systemic relevance can refer to: (i) systemically important financial institutions that fall into the main criteria enclosed in the guideline; or (ii) other financial institutions, not necessarily cross-border, whose insolvency could have a significant negative impact on the financial system because of adverse market circumstances or financial stress.

➤ **E3 – What is the request procedure?**

The request should be addressed to the Chairperson of the ESM Board of Governors, indicating the institutions in distress for which financial assistance is requested, the amount of capital needed, the type of securities to be used in the recapitalisation, and the results of a recent stress-test of the institutions concerned.

The Board of Governors will then entrust the European Commission, in liaison with the ECB and where possible the relevant ESA, to assess conformity with the eligibility criteria. Based on this assessment, the Board of Governors, acting on a proposal from the Managing Director, will decide whether to grant the loan. In addition, the beneficiary ESM Member will give notice of the proposed recapitalisation to the European Commission, which will examine its compatibility with EU state aid rules.

➤ **E4 – Will conditions be attached?**

Yes, but unlike stability support within a macro-economic adjustment programme, the conditionality focuses only on the financial sector of the country in question. Conditionality will apply in the domains of financial supervision, corporate governance and domestic laws relating to restructuring/resolution. The policy conditions will be specified in an MoU negotiated by the European Commission in liaison with the ECB and relevant European Supervisory Authority.

➤ **E5 – How will the loan be disbursed?**

Recapitalisation loans will be provided in one or more tranches, which may each consist of one or more disbursements. Disbursements of tranches, subsequent to the first tranche, will be made upon a decision, by mutual agreement, of the Board of Directors, following a proposal from the Managing Director and after having received the report conducted by the European Commission, in liaison with the ECB.

➤ **E6 – Are recapitalisation loans paid in cash?**

Loans to ESM Members for the recapitalisation of financial institutions are generally paid in kind, i.e. no cash is involved. For this purpose, the ESM/EFSF issues notes (i.e. bills and/or bonds) through a process known as the Issue and Repurchase Process (IRP).

Whenever financial assistance is to be disbursed in the form of ESM/EFSF notes, as a first step the ESM/EFSF notes need to be created, which requires for such notes to be acquired for a certain value.

The process works as follows: the ESM/EFSF issues notes to a counterparty (a bank belonging to the ESM/EFSF Market Group which meets specific criteria), which subscribes for the notes and pays the issue price. The notes are then immediately repurchased by the ESM/EFSF. Both transactions occur on the same day and at the same price. No gains or losses are linked to the process. The notes are then held in treasury by ESM/EFSF for later transfer. The pricing of the notes is done at market price, which means at a level similar to the price of outstanding ESM/EFSF notes in the secondary market. The notes are finally transferred to a Beneficiary Member State, e.g., for the purpose of recapitalising its banking sector, in which case the disbursed notes may be used by the recapitalised banks as collateral for repo transactions with commercial or central banks.

The IRP provides the ESM/EFSF with the possibility to provide funding to Beneficiary Member States in a short period of time.

E7 – Who will monitor compliance with institution-specific conditionality?

Compliance with institution-specific conditionality related to EU state aid rules will be conducted by the European Commission, which will also be responsible for the monitoring of other policy conditions in liaison with the ECB and the relevant European Supervisory Authority (ESA). The ESAs will have the

right to conduct on-site inspections in any beneficiary financial institution(s) in order to adequately monitor compliance with the conditions, and share information relevant to the reporting on compliance with the European Commission and the ECB. Where deemed necessary, the monitoring institutions shall also be authorized to involve other relevant experts, such as external auditors or monitoring trustees.

An additional assessment by the IMF of the implementation of international standards and supervisory practices should be actively sought by the beneficiary ESM Member during the period of implementation of the financial assistance.

Questions regarding the use of EFSF/ESM notes in respect of a financial institution recapitalisation facility

- E8 – Are there any non-customary selling restrictions included in the issue documentation (Prospectus/Information Memorandum of the Debt Issuance Programme and/or Final Terms) which would bind any note holder regardless of the notes' origin?

No, currently there are no such restrictions.

- E9 – Is a bank which has received notes issued by EFSF or ESM as part of a financial institution recapitalisation programme restricted in how it can use such notes?

Yes, on a bilateral basis (i.e. such restrictions would not apply to any third parties unless the relevant recapitalised bank itself would introduce similar restrictions into a contractual relationship with such third party).

- E10 – What are these bilateral restrictions?

A recapitalised bank cannot sell the notes outright into the market. It can, however, use the notes to obtain liquidity (i) from the European Central Bank; (ii) from the relevant national central bank; or (iii) through entering into repurchase transactions with market counterparties.

- E11 – Are there restrictions on the use of notes issued by EFSF or ESM for repurchase transactions with market counterparties?

Yes, a recapitalised bank has to ensure that the relevant transaction documentation includes the right to repurchase and to obtain redelivery of the same Notes (i.e. Notes with the same ISIN) at the end of the relevant repurchase transaction, provided that such right may remain subject to customary close-out provisions in repo documentation in case of a default of the relevant recapitalised bank.

- E12 – Can the ESM/EFSF request redelivery of their notes at any time?

In principle, yes. As a precondition for its receipt of the notes as part of a financial institution recapitalisation programme, each recapitalised bank has to agree to redeliver such notes upon the occurrence of certain events. However, such obligation would *not* apply where the relevant recapitalised bank no longer holds (and cannot obtain redelivery of) such notes as a consequence of the repo operation.

- E13 – Can the ESM/EFSF unilaterally force a recapitalised bank to adhere to further conditions on the use of their notes which are introduced at some point in the future?

Some recapitalised banks have agreed to allow the EFSF/ESM, the ECB and the relevant central bank to unilaterally introduce additional conditions (e.g. selling restrictions or collateral requirements) in the future. However, even where this is the case, such conditions would *not* apply to repurchase transactions with market counterparties which already exist at the date when such additional conditions are introduced. In other words, such conditions would have no retroactive effect.

Once conditions have been introduced, the recapitalised bank can only enter into new repurchase transactions which comply with these additional conditions. Therefore, the recapitalised bank may need to revise its standard repo documentation to conform to these conditions (i.e. the relevant market counterparty would know prior to entering into a subsequent repurchase transaction what additional conditions apply).

➤ **E14 – Have additional conditions been introduced?**

No. As at today's date, neither the EFSF/ESM, the ECB, nor the relevant Central Bank have introduced any additional conditions as referred to in E14 above.

Hence, other than the restrictions mentioned in E12 and E13 above, there are as at today's date no restrictions with respect to the use of the notes for the recapitalised banks under a financial institution recapitalisation programme.

➤ **E15 - Will the ESM make loans directly to financial institutions?**

Currently, the ESM may only lend to euro area Member States. However, on 10 June 2014, the euro area Member States reached a preliminary agreement on the future ESM direct recapitalisation instrument (DRI). The ESM DRI will become operational if the 18 euro area Member States complete their national procedures successfully and the ESM Board of Governors takes a unanimous decision to create a new ESM instrument.

Detailed information on the new instrument can be found in the [FAQ on the preliminary agreement on the future ESM direct bank recapitalisation instrument](#).

Precautionary financial assistance ¹⁶

➤ **E16 – What is the objective of the ESM's precautionary financial assistance?**

The objective of ESM precautionary financial assistance in the form of credit lines is to support sound policies and prevent crisis situations by allowing ESM Members to secure ESM assistance before they face major difficulties raising funds in the capital markets. Precautionary financial assistance aims at helping ESM Members whose economic conditions are still sound to maintain continuous access to market financing by reinforcing the credibility of their macroeconomic performance while ensuring an adequate safety-net.

➤ **E17 – What type of credit lines are available?**

Two types of ESM credit lines are available: a Precautionary Conditioned Credit Line (PCCL) and an Enhanced Conditions Credit Line (ECCL). A PCCL and an ECCL credit line can be drawn via a loan or a primary market purchase. Both types of credit line have an initial availability period of one year and are renewable twice, each time for six months.

- Precautionary conditioned credit line (PCCL) – available to a euro area Member State whose economic and financial situation is fundamentally sound, as determined by respecting eligibility criteria (sustainable public debt, respect of commitments under excessive deficit procedure (EIP), track record of access to capital markets on reasonable terms, sustainable external position, and the absence of bank solvency problems that would pose systemic threats to the stability of the euro area banking system). The beneficiary country will be obliged

¹⁶ See ESM Guideline on Precautionary Financial Assistance, <http://www.esm.europa.eu/pdf/ESM%20Guideline%20on%20precautionary%20financial%20assistance.pdf>

to respect the eligibility criteria after the PCCL is granted.

- Enhanced conditions credit line (ECCL) – Access open to all euro area Member States whose general economic and financial situation remains sound but do not comply with some of the eligibility criteria for accessing a PCCL. The beneficiary ESM Member will be obliged to adopt corrective measures aimed at addressing such weaknesses and avoiding any future problems in respect of access to market financing, while ensuring a continuous respect of the eligibility criteria which were considered met when the credit line was granted.

➤ E18 – What is the procedure for granting precautionary financial assistance?

As with other forms of assistance, a request must be addressed to the Chairperson of the ESM Board of Governors, who will then entrust the European Commission in liaison with the ECB to assess whether the potential beneficiary country meets the required conditions and to evaluate its financing needs. An MoU will be negotiated and signed by the European Commission and an FFA detailing the financial terms and conditions of the assistance will be prepared by the Managing Director and adopted by the Board of Governors.

➤ E19 – How will a credit line be activated?

A credit line will be activated at the initiative of the beneficiary ESM Member. The Member will have the flexibility to request the draw-down of funds at any time during the availability period of the credit line according to the agreed terms. It will inform the ESM at least a week in advance of its intention to draw funds, depending on the intended size.

➤ E20 – Will beneficiary countries be subject to enhanced surveillance?

Yes, when an ECCL is granted or a PCCL drawn, the ESM Member will be subject to enhanced surveillance by the European Commission for the availability period of the credit line. The scope of surveillance will include information regarding the beneficiary country's financial condition and developments in its financial system. On a request from the European Commission, the beneficiary ESM Member will also be required to carry out stress tests or sensitivity analyses to assess the resilience of the financial sector to various shocks and be subject to regular assessments of its supervisory capacities over the banking sector in the form of a peer review carried out by the relevant ESA. In addition, the beneficiary country will be obliged to carry out and report on a comprehensive independent audit of the accounts of the general government conducted in coordination with national supreme audit institutions, aiming at assessing the reliability, completeness and accuracy of these public accounts for the purposes of the excessive deficit procedure.

The European Commission will conduct, in liaison with the ECB and the European Supervisory Authorities as needed, and where appropriate the IMF, regular review missions in the ESM Member under surveillance to verify the progresses made in the implementation of the adopted measures. It will communicate, every quarter, its findings to the Board of Directors and assess whether further policy measures are needed.

➤ E21 – Will there be an assessment of the adequacy of the credit lines?

The adequacy of the precautionary financial assistance will be assessed on a proposal from the ESM Managing Director based on the findings of the review mission or, where a PCCL has been granted but not drawn, the results of the regular EU multilateral surveillance procedure. The Board of Directors will decide on the basis of this proposal whether the credit line should be maintained.

Primary Market support facility ¹⁷

¹⁷ See ESM Guideline on the Primary Market Support Facility,

➤ E22 - What is the objective of the ESM's Primary Market Support Facility (PMSF)?

The ESM may engage in primary market purchases of bonds or other debt securities issued by ESM Members to allow them to maintain or restore their relationship with the dealer/investment community and therefore reduce the risk of a failed auction. It would also serve to increase efficiency of ESM lending.

➤ E23 – Which countries could benefit from ESM primary market intervention?

Bond purchase operations in the primary market could be made in complement to regular loans under a macroeconomic adjustment programme or to drawdown of funds under a precautionary programme. This instrument would be used primarily towards the end of an adjustment programme to facilitate a country's return to the market.

➤ E24 – Would conditionality be attached?

Conditions would be those of the macroeconomic adjustment programme or precautionary programme.

➤ E25 – What is the relation between the ESM's primary market intervention and the ECB's Outright Monetary Transactions (OMT)?

As announced by ECB President Mario Draghi on 6 September 2012, Outright Monetary Transactions, i.e. is the purchase of euro area sovereign bonds on the secondary market by the ECB, will be considered for future cases of EFSF/ESM macroeconomic adjustment programmes or precautionary programmes, provided that they include the possibility of EFSF/ESM primary market purchases. OMT may also be considered for Member States currently under a macroeconomic adjustment programme when they will be regaining bond market access.

➤ E26 – What is the procedure for using PMSF for the disbursement of a loan?

If an ESM Member requests the use of a PMSF when requesting a loan, the same procedure as in the case of stability support loans applies (see question D2). If an ESM Member requests the use of PMSF after having entered into a loan facility, the ESM's Managing Director will prepare a proposal within the overall financial limit of the loan facility whether to grant the PMSF, to be adopted by the Board of Governors. The Managing Director will then prepare a proposal for a revised financial assistance facility agreement (FFA) covering the financial terms and conditions of the PMSF, to be adopted by the Board of Directors.

An ESM Member to which a PMSF has been granted should inform the Managing Director of its intention to have one or several tranches under a loan facility disbursed via primary market purchase. The Board of Directors will allow the disbursement after having received the last report by the European Commission in liaison with the ECB on the compliance by the beneficiary Member with the policy conditionality attached to the assistance facility.

In the case of an ESM Member to which a stability support in the form of a credit line has been granted, that Member should inform at least a week in advance, or as otherwise agreed in the facility agreement, the ESM Board of Directors of its intention to draw down funds via primary market purchase. The Managing Director will agree with the beneficiary ESM Member the detailed modalities for carrying out the PMSF. This agreement will be updated regularly with a view to taking into account the evolution of the market situation of the beneficiary ESM member.

➤ E27 – How will the primary market purchases be implemented?

<http://www.esm.europa.eu/pdf/ESM%20Guideline%20on%20the%20primary%20market%20support%20facility.pdf>

Primary market purchases will as a rule be conducted at market price. The manner of implementation will depend on the issuance approach taken by the ESM member:

- *Via a participation in auctions*, at the average weighted price of the auction. The amount purchased by the ESM will, as a rule, be limited to 50% of the final issued amount. This proportion will, however, be increased if market bids at acceptable prices are insufficient, with a view to ensuring that the amount sold by the beneficiary ESM Member is equivalent to at least half of the originally targeted amount.

or

- *Via participation in syndicated transactions*, at the re-offer price. The amount purchased by the ESM will, as a rule, be limited to 50% of the final issued amount. This proportion will, however, be increased if the order book is insufficient, with a view to ensuring that the amount sold by the beneficiary ESM Member is equivalent to at least half of the originally targeted amount.

- E28 – Would the ESM carry out the primary market purchase if there was insufficient demand from private investors?

No, the primary market purchase would not be carried out if the ESM's Managing Director concludes that the participation of private investors would be insufficient or if the rate would be excessively above the ESM funding rate. Where appropriate, the purchase of bonds would then be replaced by a regular draw-down of funds.

- E29 –What would the ESM do with the bonds purchased?

Once purchased by the ESM, securities could be

- resold to private investors when market conditions have improved
- held until maturity
- sold back to the beneficiary ESM Member
- used for repos with commercial banks to support liquidity management of the ESM

Secondary Market Support Facility ¹⁸

- E30 - What is the objective of ESM's Secondary Market Support Facility (SMSF)?

The Secondary Market Support Facility aims to support the good functioning of the government debt markets of ESM Members in exceptional circumstances where the lack of market liquidity threatens financial stability, with a risk of pushing sovereign interest rates towards unsustainable levels and creating refinancing problems for the banking system of the ESM Member concerned. An ESM secondary market intervention is intended to enable market-making that would ensure some debt market liquidity and incentivise investors to further participate in the financing of ESM Members.

- E31 – Which countries would be eligible for ESM secondary market intervention?

Secondary market support could be provided for ESM Members under a macroeconomic adjustment programme and also for non-programme Members whose economic and financial situation is fundamentally sound, as determined by respecting eligibility criteria (sustainable public debt, respect of commitments under excessive deficit procedure (EIP), track record of access to capital markets on reasonable terms, sustainable external position, and the absence of bank solvency problems that would pose systemic threats to the stability of the euro area banking system).

¹⁸ See ESM Guideline on the Secondary Market Support Facility, <http://www.esm.europa.eu/pdf/ESM%20Guideline%20on%20the%20secondary%20market%20support%20facility.pdf>

➤ E32 –Would conditionality be attached?

For countries under a macroeconomic adjustment programme, the conditionality of that programme applies. For ESM Members outside of a macroeconomic adjustment programme, an MoU detailing the policy conditions would be negotiated with the ESM Member concerned by the European Commission in liaison with the ECB.

➤ E33 –What would be the procedure to activate secondary market support?

The procedure would be initiated by a request from an ESM Member to the Chairperson of the Board of Governors, who will entrust the ECB to assess whether there are exceptional market circumstances and whether there is a risk to the financial stability of the euro area as a whole or of its Member States. In addition, the European Commission, in liaison with the ECB, will determine whether the Member's public debt is sustainable and assess its financing needs. On the basis of a proposal by the Managing Director, the Board of Governors will make a decision whether to grant secondary market support. For non-programme countries, an MoU will then be negotiated and signed. The Managing Director will then prepare a financial assistance facility agreement (FFA), specifying the financial terms and conditions under which the secondary market purchases are to be conducted, to be adopted by the Board of Governors.

➤ E34 –Will there be any caps on the volume of intervention?

Yes, the Board of Directors will establish pro-tempore intervention caps for the implementation of SMSF.

➤ E35 –What would ESM do with the bonds purchased?

As with purchases in the primary bond market, securities purchased by ESM on the secondary bond markets could be either resold to private investors when market conditions have improved, held until maturity, sold back to the beneficiary country or used for repos with commercial banks to support ESM's liquidity management.

➤ E36 –How will the ESM buy on the secondary markets?

A technical sub-committee will be established to decide on the implementation of secondary market interventions. The European Central Bank (ECB) will act as fiscal agent for the ESM.

➤ E37 – Are you considering pre-funding to be equipped for secondary market purchases?

This is not an issue currently under consideration.

➤ E38 –Will the ESM take over bonds previously bought by the ECB?

This is not intended at this stage.

Section F – Financial assistance for Spain (concluded 31 December 2013)

➤ F1 – Why did Spain need financial assistance?

The disproportionate growth in the real estate sector, along with the expansion of credit needed to finance it, was the main reason behind Spain's economic imbalances. In the real estate sector, a spiral of growth in demand, prices and supply fuelled a major bubble, which burst when the impact of the international financial crisis was felt in Spain. The massive scale of loans granted to construction and

property development activities caused an excessive exposure of the banking industry to those sectors. In particular, Spain's savings banks (*Cajas de Ahorros*), whose weight in the sector was close to 50%, were affected by solvency problems.

A restructuring process was started by the Spanish authorities in 2010. However, the economic downturn turned out deeper and more protracted than expected. The funding costs for Spain as well as Spanish banks significantly increased. These tightening market conditions raised widespread concern that private and public resources would be insufficient to support the banking system with capital.

➤ F2 – How much was the financial assistance for Spain?

On 25 June 2012, the Spanish government made an official request for financial assistance for its banking system to the Eurogroup for a loan of up to €100 billion. The results of a diagnostic exercise, commissioned by the Spanish authorities to external evaluators, indicated that the additional capitalisation needs of the Spanish banking sector as a whole could be estimated in the range of €51-62 billion. Including a safety margin, it was assessed that these capital needs would remain within the envelope approved by the Eurogroup of up to €100 billion.¹⁹

On 3 December 2012 the Spanish government formally requested the disbursement of €39.47 billion for the recapitalisation of the banking sector. The funds were transferred in the form of ESM notes on 11 December 2012 to the Fondo de Reestructuración Ordenada Bancaria (FROB), the bank recapitalisation fund of the Spanish government. The FROB used these notes for the recapitalisation, in an amount close to €37 billion, of the following banks: BFA-Bankia, Catalunya-Caixa, NCG Banco and Banco de Valencia. Additionally the FROB was to provide up to €2.5 billion to SAREB, the asset management company for assets arising from bank restructuring.

On 28 January 2013, the Spanish government formally requested the disbursement of €1.86 billion for the recapitalisation of the following banks: Banco Mare Nostrum, Banco Ceiss, Caja 3 and Liberbank. The funds were transferred to the FROB in the form of ESM notes on 5 February 2013.

No further requests for disbursement were made, thus the overall amount of financial assistance provided by the ESM to Spain was €41.33 billion.

➤ F3 – Who determined which financial institutions would receive funds?

This was decided by the Bank of Spain in agreement with the European Commission in liaison with the ECB, EBA and the IMF, and following a stress test of all banking groups.

➤ F4 – Did the ESM provide loans directly to Spanish financial institutions?

No. The FROB, acting as agent of the Spanish government, eventually received the funds and channelled them to the financial institutions concerned. This is a loan to the sovereign and the Spanish government remains responsible for its repayment.

➤ F5 – What is the status of ESM financial assistance for Spain?

As the financial assistance for Spain was originally to be provided by the EFSF, the Eurogroup decided that the ESM assistance programme would maintain the status of EFSF loans (i.e. *pari passu*) rather than follow the preferred creditor status of ESM loans.²⁰ This was reaffirmed by the euro area summit

¹⁹ For the Eurogroup statement following Spain's intention to seek financial assistance on 9 June, <http://estaticos.elmundo.es/documentos/2012/06/09/eurogrupo.pdf>

²⁰ http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/131309.pdf

of 29 June 2012.²¹

➤ F6 – How were the funds raised?

For the initial disbursement of €39.47 billion, the ESM launched and priced two bills and three floating rate notes for the financial assistance to be provided for the Spanish banking sector via FROB. For the second tranche of assistance, amounting to €1.86 billion, the ESM launched and priced a floating rate note.²²

➤ F7 – When will Spain have to repay the loans?

Spain will repay the loan principal starting in from 2022, and the repayment is scheduled to end in 2027. The average maturity of the loan tranches is 12.5 years. The payment of annual fees and interest, in line with the ESM Pricing Policy, has already started.²³

➤ F8 – What were the conditions attached to the financial assistance?

The bank-specific conditionality comprised three key elements. First, identifying individual bank capital needs through an asset quality review of the banking sector and a bank-by-bank stress test. Second, recapitalising and restructuring weak banks based on plans to address any capital shortfalls identified in the stress test. Finally, problematic assets in those banks receiving public support (without any credible plans to address their capital shortfalls by private means) were to be segregated and transferred to an external asset management company (Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria – SAREB).

In addition, so-called ‘horizontal conditionality’ was also applied in order to strengthen the banking sector as a whole. This included regulatory capital targets, bank governance rules, an upgrade of reporting requirements and improved supervisory procedures.

➤ F9 – What were the conditions for the Commission to approve state aid for banks?

The approval process is linked to the existence of a credible restructuring plan, which demonstrates in a convincing manner how the bank will return to viability without needing further state aid. The plan has to show as well how the bank minimises the cost for the taxpayer and measures for mitigating competition concerns. Such a plan was submitted in the form of a legal commitment by Spain. In that context, the Commission has provided detailed guidance regarding the pricing of State guarantees, recapitalisations and asset relief measures respectively in the Banking Communication, the Recapitalisation Communication and the Impaired Assets Communication as well in the Communication of 1 December 2011.²⁴

The restructuring plans were submitted for Commission approval as foreseen by the Memorandum of Understanding (MoU), agreed between Spain and the Eurogroup in July 2012.

On 28 November 2012 the European Commission concluded²⁵ that the restructuring plans of the four Spanish banks BFA/Bankia, NCG Banco, Catalunya Banc and Banco de Valencia were in line with EU state aid rules. A similar decision concerning the four other banks receiving support (Banco Mare

²¹ http://consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf

²² For more information on the notes issued by the ESM, please consult the ESM press release: <http://www.esm.europa.eu/pdf/ESM%20press%20release%20ESM%20issues%20bonds%20for%20the%20recap%20of%20Spanish%20banks%2004122012.pdf>

²³ <http://www.esm.europa.eu/pdf/Pricing%20guideline.pdf>

²⁴ For further information, please consult the respective Communications at the website of the European Commission's Directorate General for Competition: http://ec.europa.eu/competition/state_aid/legislation/temporary.html

²⁵ http://europa.eu/rapid/press-release_IP-12-1277_en.htm

Nostrum, Banco Ceiss, Caja 3 and Liberbank) was taken by the Commission on 20 December 2012.²⁶

➤ F10 – Was the IMF involved in the financial assistance for Spain?

Yes, though only in an advisory and monitoring capacity. The IMF did not make a financial contribution because it does not have a sectoral financial assistance tool matching the one provided by the ESM.

➤ F11 – Has ESM financial assistance helped Spain to restructure its banking sector?

Yes. ESM assistance was key in cleaning the balance sheets of troubled banks, improving their capital base and overcoming market fears about the depth of the problems in Spain's financial sector.

According to a statement published following the conclusion of the 5th quarterly review of the ESM programme in December 2013,²⁷ the process of restructuring of banks having received state aid is well underway, guided by the restructuring plans as adopted by the European Commission. Compliance with the horizontal policy requirements in the MoU is nearly complete, which translates into higher resilience of the banking sector going forward.

Moreover, the efforts undertaken by the Spanish authorities have been acknowledged by financial markets. The yield on Spain's 10-year bonds has fallen considerably (from 7.5% in July 2012 to 3.9% in November 2013), which has allowed the Spanish government to obtain long-term financing.

➤ F12 – Will the Spanish economy be subject to surveillance now that the ESM financial assistance programme expired?

The ESM Treaty requires the ESM to establish an early warning system to ensure that beneficiary countries are capable of repaying their obligations. Therefore, the ESM will continue to monitor developments in the Spanish economy until full repayment of the outstanding ESM loans. The "Two-Pack" regulation established moreover the post-programme surveillance procedure, according to which the European Commission in liaison with the ECB will monitor the country. The post-programme surveillance does not entail any new policy conditionality beyond reforms requested under the European governance framework.

Section G – Financial assistance for Cyprus

➤ G1 – What is the purpose of the programme?

The programme will address the exceptional financial, budgetary and structural challenges that Cyprus is facing. The programme aims to restore financial stability and reduce the size of the financial sector to a viable level, promote sustainable growth, and sound public finances over the coming years.

➤ G2 – What is the size of the programme?

The total amount of financial assistance, agreed by the Eurogroup, is up to €10 billion. Out of this amount, the ESM will provide approximately €9 billion, and the IMF will contribute around €1 billion. The

²⁶ http://europa.eu/rapid/press-release_IP-12-1432_en.htm

²⁷ http://europa.eu/rapid/press-release_MEMO-13-1153_en.htm

programme is to cover Cyprus's financing needs over three years (from Q2 2013 to Q1 2016) after the inclusion of proceeds from burden-sharing measures adopted by the Cypriot government.

- **G3 – What policy measures were taken by the Cypriot authorities with regard to the Bank of Cyprus and the Cyprus Popular Bank (Laiki)?**

The BoC was capitalised through the full contribution (bail-in) of the shareholders and bondholders of the bank and through the conversion of 47.5% of uninsured deposits (over €100,000) into equity.

After exiting the resolution, the new BoC became adequately capitalised with a CT1 capital ratio of around 12%. This ensures that the CT1 capital ratio of the bank will stay above the regulatory minimum of 9% during the programme period. The new BoC, with the assistance of its external advisors, will devise its restructuring plan, to be finalised by mid-October 2013.

The resolution of Laiki minimised the use of taxpayers' money with a full bail-in of equity shareholders and bondholders, and a partial bail-in of uninsured depositors. All deposits under €100,000 were fully protected.

As a result, Laiki was split in two units. While all uninsured deposits were kept in a legacy unit (Legacy Laiki), the insured deposits were transferred together with certain assets and liabilities to the BoC. In exchange for the positive net asset position transferred, the Legacy Laiki received shares of the BoC. The uninsured depositors of Laiki will be compensated through the liquidation of the assets of Legacy Laiki which also include these shares in the BoC.

- **G4 – Why were uninsured depositors part of the bail-in?**

Given the large banking recapitalisation needs, as well as the acute public finance problems, it became necessary to include uninsured depositors in the bail-in in order to ensure the sustainability of public debt. Imposing losses only on shareholders and bondholders was not sufficient to finance the restructuring of Cyprus's two largest banks (Bank of Cyprus and Laiki). Even after taking all these measures into account, the financial assistance of €10 billion provided by the ESM and IMF will be among the largest in the euro area, in GDP terms.

- **G5 – Will the bail-in of depositors be used to recapitalise other banks in the system, e.g. Hellenic Bank and cooperative credit institutions?**

There will be no depositor bail-in beyond the one already completed at the BoC and Laiki. Hellenic Bank has announced that it aims to raise private capital in order to meet the capital requirements set under the programme by the end of September 2013. In case private sector funds do not cover in full the required capital increase, the bank will be recapitalised in line with state aid rules. No depositor bail-in will be requested.

Recapitalisation of the cooperative credit sector will occur through state aid, which will be financed by programme resources. To this end, €1.5 billion of the financial assistance has been reserved. Again, no bail-in of depositors will be requested.

- **G6 – Will any uninsured deposits from public authorities be exempted? What about EU structural funds?**

According to the resolution decrees the bank deposits of the central government and local authorities will be exempt from the bail-in. Such deposits also include payments from the European Union for the co-funding of projects.

➤ G7 – What happened to the branches of Cypriot banks in Greece?

The branches of Laiki, Bank of Cyprus and Hellenic Bank in Greece have been acquired by Piraeus Bank. They reopened on 27 March 2013.

➤ G8 – Will any money from the programme go to the financial sector?

No programme money will be used for recapitalising Laiki or Bank of Cyprus. However, other Cypriot banks and the cooperative credit sector are eligible for assistance from the programme envelope under state aid rules.

➤ G9 – What is the policy conditionality specified in the MoU?

The key objectives of the MoU programme are:

- to restore the soundness of the Cypriot banking sector and rebuild depositors' and market confidence by thoroughly restructuring and downsizing financial institutions, strengthening supervision and addressing expected capital shortfalls;
- to continue the on-going process of fiscal consolidation in order to correct the excessive general government deficit by 2016, in particular through measures to reduce current primary expenditure, and maintain fiscal consolidation in the medium-term, in particular through measures to increase the efficiency of public spending within a medium-term budgetary framework, enhance revenue collection and improve the functioning of the public sector; and
- to implement structural reforms to support competitiveness and sustainable and balanced growth, allowing for the unwinding of macroeconomic imbalances, in particular by reforming the wage indexation system and improving the functioning of services markets.

➤ G10 – Cyprus's problems were partly due to the overexposure of Cypriot banks to Greek sovereign debt. Has anything been done to prevent this from happening in the future?

Yes. To avoid similar outcomes in the future, the Central Bank of Cyprus will update relevant liquidity regulations by December 2014, after consultation with the ECB, European Commission and the IMF.

➤ G11 – Are anti-money laundering measures included in the MoU?

Yes. The Cypriot authorities are committed to further enhancing the anti-money-laundering framework. To this end, an independent audit was carried out by Moneyval²⁸ and Deloitte which was finalised in early May 2013.²⁹ The recommendations of the independent audit will be implemented as part of a comprehensive action plan, which has been included as an annex to the MoU. The measures include the establishment of trust registers and a third-party assessment of the functioning of the Registrar of Companies. Cooperation with foreign financial intelligence units will be further strengthened.

➤ G12 – What is the timeline for restoring the sustainability of Cyprus's public finances?

A good measure of the soundness of public finances is the budget balance before interest payment, i.e. the primary balance. Cyprus is expected to see this indicator stabilise at 4% of GDP from 2018

²⁸ MONEYVAL is the acronym of the Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism, established by the Council of Europe in 1997.

²⁹ A summary of the findings is available at: http://www.centralbank.gov.cy/ngcontent.cfm?a_id=12806

onwards. The debt to GDP ratio is expected to peak at around 126% of GDP in 2015 to decline to around 122% of GDP in 2016 and to around 105% in 2020.

➤ **G13 – How much has already been disbursed to Cyprus?**

The first tranche of ESM financial assistance was transferred to Cyprus in two separate disbursements. The first disbursement of €2 billion was made on 13 May 2013. The second disbursement of €1 billion was transferred on 26 June 2013. The funds disbursed under the first tranche were used to finance fiscal needs and the redemption of maturing debt.

The second tranche of ESM financial assistance in the amount of €1.5 billion will be disbursed by the end of September, following the finalisation of the first review procedure. The proceeds of the second tranche will be used for the recapitalisation of cooperative credit institutions. The funds disbursed under the first tranche are to be used for fiscal needs and to finance the roll-over of maturing debt.

➤ **G14 – What will be the maturity of loans granted to Cyprus?**

The average maturity of all loans will be 15 years, with a maximum maturity of 20 years.

➤ **G15 – What will be the financing cost for Cyprus?**

In accordance with the ESM Pricing Guideline, the financing cost of an ESM loan is the sum of the following fees:

- i. Base rate – the cost of funding incurred by the ESM, derived by a daily computation of the actual interests accrued on all of the bonds, bills and other funding instruments issued by the ESM.
- ii. Commitment fee – the negative cost of carry³⁰ and issuance costs, charged for the period from raising funds by the ESM until disbursement to the Beneficiary Member State or for the period from the refinancing of relevant funding instrument until its maturity. The commitment fee will be applied ex-post on the basis of the negative carry actually incurred.
- iii. Service fee – the source of general revenues and resources to cover the ESM's operational costs. The service fee has two components: (i) up-front service fee (50 bps) deducted from the drawn amount, (ii) annual service fee (0.5 bp) paid on the interest payment date.
- iv. Margin – (10 bp) according to ESM pricing guidelines for a macro-economic adjustment program, accruing day to day with effect from the first interest payment date of the relevant disbursement of the first tranche.

➤ **G16 – How will the programme be monitored?**

The European Commission, in liaison with the ECB and IMF, will verify at regular intervals that the policy conditions attached to the financial assistance are fulfilled, through missions and regular reporting by the Cypriot authorities, on a quarterly basis.

➤ **G17 – Why were capital controls introduced by the Cypriot authorities?**

³⁰ Negative cost of carry reflects the fact that the interest rate at which ESM raises funds would most likely be higher than the return obtained for shorter-term investments in high quality assets [lay out is different from other footnotes...]

Restrictive measures had to be introduced so as to protect the financial stability of the Cypriot banking system. This refers in particular to preventing large deposit outflows and preserving the solvency and liquidity of credit institutions. These extraordinary measures should be dropped over time and significant changes have been introduced, especially since the entry into force of the 10th Decree (end of April).

➤ **G18 – What measures are still in place?**

Current restrictive measures mainly apply to the cashing of cheques, cross border transfers, domestic transfers above a certain amount, the withdrawal or export of cash and the opening of accounts. In other areas there are no restrictions, e.g. payment card transactions or incoming payments from abroad.

A complete list of decrees is available here:

Ministry of Finance:

http://www.mof.gov.cy/mof/mof.nsf/page01_en/page01_en?OpenDocument

Central Bank of Cyprus:

http://www.centralbank.gov.cy/nqcontent.cfm?a_id=12636&lang=en

➤ **G19 – How long are restrictive measures going to stay in place and when will they be relaxed?**

The Cypriot authorities have published (on 8 August) a roadmap which identifies a series of milestones for the gradual relaxation of the remaining measures. The roadmap foresees two major stages of relaxation: the first pertains to measures within Cyprus and the second relates to cross-border movements of capital.³¹

➤ **G20 – Are these controls legal under EU treaties?**

According to the Treaty on the Functioning of the European Union, Member States may introduce restrictions on capital movement, including capital controls, in exceptional circumstances and under strict conditions on the grounds of public policy or public security. In accordance with the case law of the European Court of Justice, measures may also be introduced for overriding reasons of general public interest.

Such exception to the principle of the free movement of capital must be interpreted very strictly and be non-discriminatory, suitable, proportionate and applied for the shortest possible period.

In current circumstances, the stability of financial markets and the banking system in Cyprus constitutes a matter of overriding public interest and public policy justifying the imposition of temporary restrictions on capital movements.

While the imposed restrictive measures were necessary in the current circumstances, the free movement of capital should be reinstated as soon as possible in the interests of the Cypriot economy and the European Union's single market as a whole.

➤ **G21 – Has Cyprus stepped out as a guarantor of the EFSF?**

³¹ The roadmap is available at:

[http://www.mof.gov.cy/mof/mof.nsf/All/3766C4D62B9EDE71C2257BC2002E22E9/\\$file/Roadmap%20PresentationLHM07%208%202012ENG%20\[Compatibility%20Mode\].pdf](http://www.mof.gov.cy/mof/mof.nsf/All/3766C4D62B9EDE71C2257BC2002E22E9/$file/Roadmap%20PresentationLHM07%208%202012ENG%20[Compatibility%20Mode].pdf)

Yes. Under the EFSF Framework Agreement, a euro area Member State experiencing severe financial difficulties and requesting a stability support loan or benefit from financial support under a programme, can request to have its commitment to provide further guarantees suspended. Cyprus made such a request it was approved by the Eurogroup Working Group (EWG) on 29 April 2013.³² The liability of Cyprus as a guarantor for notes issued prior to its stepping out is not affected.

➤ G22 – Is the programme for Cyprus a template for crisis management in the future?

While it is clear that the Cyprus case does not represent a template *per se* for future financial assistance programmes, the issue of burden sharing in future bank restructuring is a topic under discussion. The EU finance ministers have reached an agreement in June 2013 on a general approach to establish a framework for the recovery and resolution of failing banks, which may see a final approval by the European Parliament before the end of this year. This approach aims to create a harmonised rulebook for the allocation of the costs of bank failure: it starts with the bail in of bank shareholders and creditors, and it is backed by financial support from resolution funds sourced from the banking sector instead of taxpayers.

³² For information concerning the changed EFSF contribution key following Cyprus's stepping out as a guarantor, please consult:
<http://www.efsf.europa.eu/attachments/EFSF%20supplement%20to%20the%2011%20February%202013%20prospectus.pdf>

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