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Ratings

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European Stability Mechanism

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European Stability Mechanism

This article does not constitute a rating action

Stand-alone credit profile	aaa	+	Extraordinary shareholder support	0	+	Holistic approach	0

Enterprise risk profile

Extremely strong	Very strong	Strong	Adequate	Moderate	Weak	Very weak

Financial risk profile

Extremely strong	Very strong	Strong	Adequate	Moderate	Weak	Very weak

Issuer credit rating
AAA/Stable/A-1+

Outlook

Issuer Credit Rating
Foreign Currency
AAA/Stable/A-1+

The stable outlook reflects S&P Global Ratings' expectation that the European Stability Mechanism (ESM) will maintain its robust enterprise risk profile because its role is to provide stability and support to euro area countries in times of crisis and wavering capital market access. We view the ESM as a key pillar for the euro area's financial architecture, alongside institutions such as the European Investment Bank (EIB) and the European Central Bank (ECB). Our outlook incorporates our view that member states will remain highly supportive of the ESM. The ESM has been assisting euro area countries during the current crisis by offering a pandemic credit line and we anticipate that it will continue to do so without damaging its financial risk profile. We forecast that the ESM's risk-adjusted capital (RAC) ratio will remain comfortably above 15%, its liquidity position will remain healthy, and its access to capital market funding will remain strong.

Downside scenario

We could lower our rating on the ESM if we considered that its policy importance has weakened, for example, because of a lack of shareholder support, or if we saw a marked deterioration in its funding and liquidity profile. The ESM's financial risk profile could weaken if there is a sizable loan disbursement that causes the RAC ratio to drop below 15%. However, if its capital ratio were eroded, we expect the effect to be mitigated by the ESM's existing eligible callable capital, provided by the 'AAA' rated members.

Rationale

We base our ratings on the ESM's extremely strong enterprise risk profile and financial risk profile. Extraordinary shareholder support for the ESM comes in the form of €624.3 billion of callable capital, of which €205.2 billion derives from its three 'AAA' rated shareholders: Germany, Luxembourg, and the Netherlands. Although we do not explicitly factor this support into the ratings, we believe that it would shield the ESM's credit quality from a potential pronounced weakening in its financial risk profile, so long as the ratings on these sovereigns, in particular Germany, do not deteriorate by more than one notch.

The ESM has a unique role as a backstop facility, similar to the International Monetary Fund (IMF), for euro area sovereigns that have lost direct market access or face funding costs that would significantly impair their fiscal position. We regard the ESM's function of safeguarding financial stability for euro area sovereigns as very important to the EU's overall financial architecture and cohesion. Since its inception, the ESM has proven its value by offering financial assistance programs to Greece, Spain, and Cyprus. We therefore consider that the ESM enjoys steadfast support from shareholders, underpinned by the entity's quick access to the largest-ever contribution of capital (€80.5 billion) and, if needed, a unique callable capital structure.

The ESM has never experienced sovereign arrears in its portfolio, and benefits from what we assess as very strong preferred creditor treatment. We expect member states to treat the ESM preferentially, given its nature as a lender of last resort.

In our opinion, the ESM benefits from sound governance and a balanced shareholder composition, comprising all members of the euro area. Moreover, the ESM has advanced risk management policies and a conservative risk tolerance. That said, credit risk is likely to be higher and more concentrated than peers, because of its policy role.

The ESM's financial profile is extremely strong, supported by our 18.5% RAC ratio (calculated using ratings on member sovereigns as of July 12, 2021). The ESM enjoys strong access to market funding and is an active issuer. It also has ample liquidity, with robust stressed liquidity ratios. As part of the ESM's liquidity risk management, its available funds should cover 12 months of liabilities at all times. We project that the ESM is prepared to operate without accessing the market for at least a year, even under stressed conditions.

Environmental, Social And Governance

Like most supranationals, we consider that the ESM faces increased scrutiny on its environmental and social impact, while structurally benefiting from shareholder support for its countercyclical role in supporting economies and livelihoods. The ESM strives to implement environmental, social, and governance best practices for its corporate activity and also from its lending operations. This includes various policies and initiatives, such as consistent tracking of its carbon footprint, and external certifications, such as becoming signatories of the United Nations Principles for Responsible Investments.

The EU has committed to reducing emissions by at least 40% by 2030, compared with 2009 levels, and while an ESM crisis response does not come with environmental conditionalities, budgetary support often serves social objectives of employment and job creation. The ESM recently launched its pandemic crisis support line, which comes with strict criteria focused on social lending to finance health-related costs linked to COVID-19. The ESM would fund the latter from social bonds, tapping sustainability-minded investors. For the ESM, rising scrutiny on environmental and social impacts common to the sector may take the form of controversies around the social effects of bailout program conditions.

The ESM has robust governance, experienced senior staff, and conservative risk management standards, in our view. However, the nature of its business leaves it exposed to higher and more concentrated credit risk than its peers.

Enterprise Risk Profile: Unique Mandate Backstopping The Euro Area's Financial Stability

- Very important mandate safeguarding the financial stability of the euro area, and providing budgetary support and crisis resolution loans to sovereigns and banking systems.
- Largest ever paid-in capital contribution of €80.5 billion in record time indicates robust shareholder support.
- Sound governance and risk management policies, in line with highly rated peers, although with a more concentrated loan book.

Policy importance

The ESM was founded in October 2012 by the "ESM treaty" to succeed the European Financial Stability Facility, which was created as a temporary rescue mechanism for euro area countries. The ESM is now viewed as a permanent resolution mechanism and has a mission of providing financial stability across the euro area. Moreover, the ESM has support from key institutions such as the European Commission (EC) and the ECB in the design and monitoring of budgetary programs. This, in our view, mitigates the ESM's somewhat shorter track record of operations compared with most established multilateral lending institutions (MLIs).

Since it was created, the ESM has provided financial assistance to three countries: Spain (€23.7 billion), Cyprus (€6.3 billion), and Greece (€59.9 billion). As of today, all programs have concluded successfully and have provided budgetary savings and financial stability. The ESM has used about 18% of its lending capacity and has €410.1 billion that could be used for future assistance.

Last year, the ESM put in place a pandemic crisis support credit facility, in line with its mission to provide financial assistance during times of crisis. Countries can request up to 2% of their 2019 GDP, as long as they use the money to support domestic financing of direct and indirect health care costs. So far, no country has put forward such a request.

The ESM's role within the euro area will be further expanded as part of a reform to the entity that was approved in 2019. All members will have to ratify the reform of the treaty during 2021. The most significant addition will be a €68 billion (maximum) backstop provided to the Single Resolution Fund. This fund is part of the Europewide banking supervision architecture and will provide emergency funding to banking systems when needed.

The ESM, together with the EC and the ECB, will also prepare, design, and monitor future country programs. It will also sign a memorandum of cooperation with the EC, with which it is working to create a common methodological working document on debt sustainability analysis. Although these new responsibilities are still pending ratification by all members, we consider that they reinforce the ESM's already very strong policy importance. Effectively, they create an IMF-like institution for the euro area. We understand that initial political difficulties have now been resolved and we expect the ratification process to be completed by the end of 2021.

The ESM's strong shareholder base consists of all euro area countries. In February 2015, Lithuania became the 19th shareholder, and no member has withdrawn since inception. As per the ESM treaty, a new member would have to contribute to the capital base according to its respective share of the EU's total population and GDP. Its largest shareholders, based on paid-in capital, are Germany (27%), France (20%), Italy (18%), and Spain (12%). All members paid their full subscription on time, demonstrating their strong support for the institution and enabling the entity to quickly build its paid-in capital. The payments were made in five tranches between October 2012, when the ESM was established, and 2014, when the capital base reached €80 billion. We expect recent euro joiners to help bring capital up to €80.8 billion by 2027.

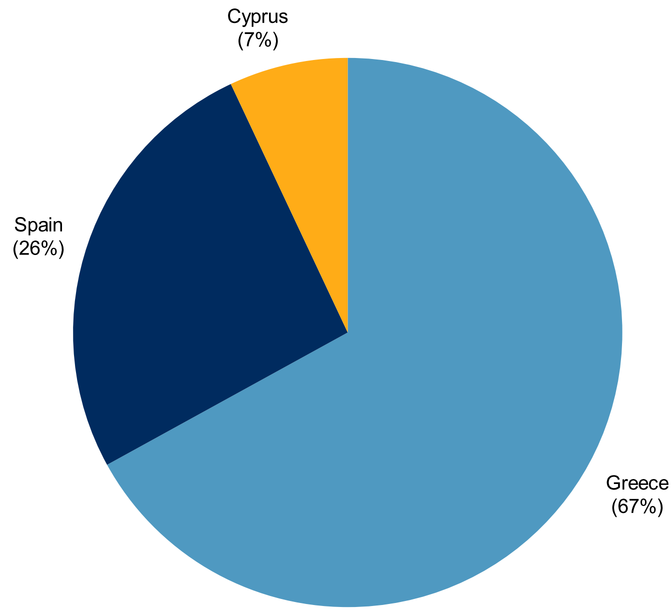
In our view, the ESM's policy importance is also strengthened by its preferred creditor treatment, which it is granted by treaty. We anticipate that ESM members will adhere to their commitments given the institution's role as a lender of last resort. If a member did not honor its obligations to an institution such as the ESM, the consequences could have political implications or jeopardize future assistance. So far, the ESM has not experienced any sovereign arrears in its portfolio and all borrowing members have made timely payments: Spain made nine voluntary early repayments between 2014 and 2018. As such, our arrears ratio is currently 0%.

As a unique feature of the ESM, shareholders can compensate the ESM for the negative interest rate that the ESM is charged on the cash held at national central banks. To limit the negative implications this could have on the ESM's paid-in capital, some members, like France and Germany, compensate the ESM for the amount. This represents an extraordinary income for the ESM and proves shareholder support and commitment toward capital preservation, in our view.

Chart 1

European Stability Mechanism's Three Largest Purpose-Related Exposures By Country

As a percentage of gross purpose-related assets plus guarantees



Source: S&P Global Ratings.

Governance and management expertise

We believe that the ESM has sound governance and risk management principles, as well as a conservative risk appetite and balanced shareholder composition comprising all members of the euro area. This is partly supported by its strong relationships with member state treasuries and the EC. That said, we expect the ESM's loan portfolio to show a higher level of risk and concentration because of the nature of its activities. For instance, loans to Greece (BB/Positive/B) represent 67% of the loan portfolio. That said, this weakness is partly mitigated by the institution's high risk-management standards and, more importantly, its robust capital structure, which includes a large capital buffer, incorporating callable capital that we see as resilient to elevated risk. The ESM uses appropriate systems to assess the risk posed by all borrowing member states, including performing a debt sustainability analysis before committing funds, as well as managing all other risks related to treasury assets, derivatives management, and foreign exchange positions.

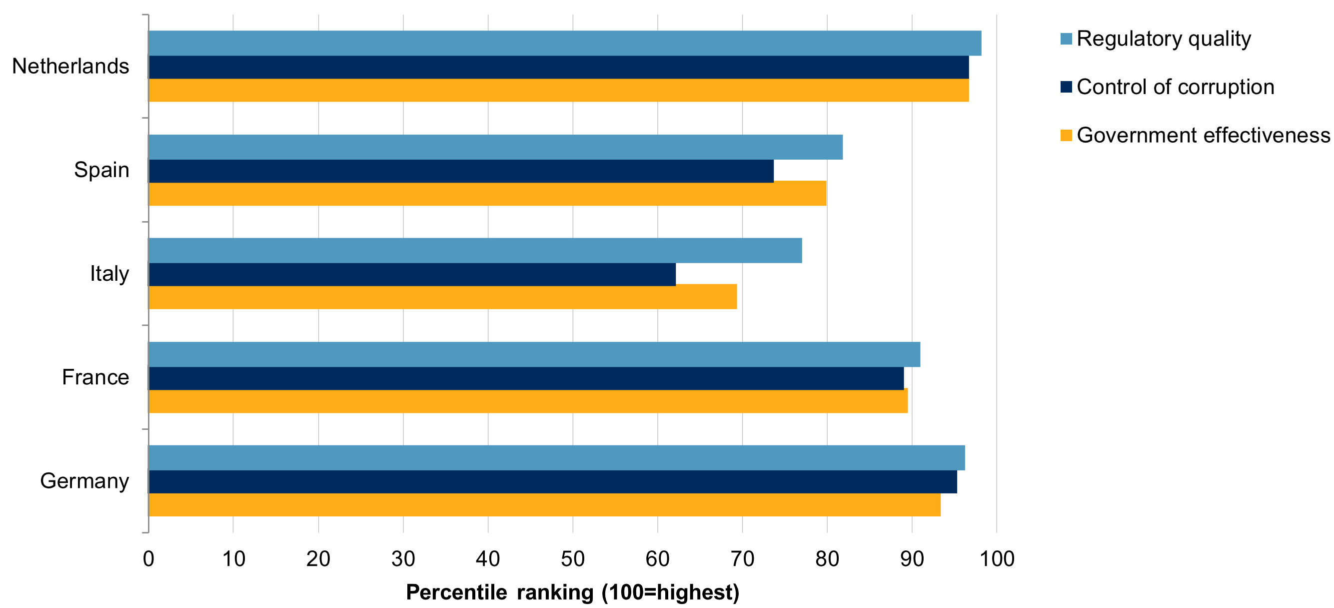
Although credit risk is higher than peers, we consider that the ESM manages it in a prudent way through its early warning system, which helps the ESM to detect if a borrower country's debt service capacity is limited and could put its payment to the ESM at risk. The early warning system is based on an assessment of each country's liquidity, market access, and debt sustainability and gives the ESM time to prepare to act, if necessary. Moreover, the ESM has strict investment policies, including derivative treatments, which are fully collateralized.

The ESM is exposed to potential risk because all shareholders can also be borrowers. We consider this is compensated for by the very high standards among the institution's major shareholders when it comes to transparency, corruption, and regulatory quality. All shareholders rank relatively high in the World Bank's governance standard indicators, and their weighted average (85) is among the highest of all MLIs. The board of governors comprises government representatives of each country and it is the highest decision-making body. It is chaired by the president of the Eurogroup. Moreover, institutions such as the EC and the ECB participate as observers in these meetings and work closely with the ESM on the design and monitoring of the assistance programs, functioning as a check and balance system for any lending decisions.

In our view, the ESM's management is experienced and its departments are staffed by an adequate number of well-trained, capable personnel. We assume the institution has capacity to comply with its mandate, particularly given its programs' solid success rate.

Chart 2

European Stability Mechanism's Five Largest Shareholders
Selected World Bank Governance Indicators



Source: S&P Global Ratings.

Financial Risk Profile: Very Strong Capital Adequacy, Strengthened By Excellent Access To Market Funding And A Robust Liquidity Position

- Robust capitalization, supported by the highest paid-in capital of all MLIs.
- Benchmark issuer in euros and U.S. dollars, providing strong funding market access.

- Robust liquidity position supporting repayment capacity, even if market access is closed off for more than 12 months.

Capital adequacy

Our RAC ratio, after adjustments for concentration risks, for the ESM is 18.5%. This is calculated using data as of end-2020; ratings on member sovereigns as of July 12, 2021; and incorporates adjustments specific to MLIs. The recent upgrade of Greece caused the RAC ratio to increase from 17.7% as of end-2019. Our RAC ratio mainly reflects ESM's exposures to its sovereign lending activity, namely, Greece, Cyprus, and Spain. Given the nature of its activity and limited diversification, the RAC ratio is materially impaired by our concentration risk adjustments.

The ESM's very strong RAC ratio is supported by its high total adjusted capital, driven by its large paid-in capital--currently €80.5 billion and the largest among the MLI sector.

Although the output of our RAC model is somewhat distorted by the risks stemming from the concentration on Greece, we have not made an adjustment. In our view, the distortion is offset by the potential for another borrower to seek support. In the absence of limits for a single borrower, a crisis could trigger a substantial increase in balance sheet usage, which could strain the RAC ratio. That said, the significant callable capital buffer from highly rated sovereigns would most likely mitigate any meaningful deterioration in the intrinsic capital level, especially if accompanied by a diversification in exposures.

The ESM's earnings capacity is limited. Although the bulk of its income stems from loan revenue, which we consider to be a stable source, returns on the liquidity portfolio and cash held at central banks have deteriorated over the past couple of years because of the low interest rates. France and Germany have provided extraordinary income as compensation for the negative interest rates on its central bank accounts.

Table 1

European Stability Mechanism Risk-Adjusted Capital Framework*

Mil. €	Exposure	S&P Global Ratings RWA	Average S&P Global Ratings RW (%)
Credit risk			
Government and central banks	124,571	66,384	53
Institutions	20,660	4,059	20
Other assets	904	942	104
Total credit risk	146,135	71,386	49
Total operational risk		4,464	
RWA before MLI Adjustments		75,850	100
MLI adjustments			
Single name (on corporate exposures)		0	0
Sector (on corporate portfolio)		0	0
Geographic		(1,587)	(2)
Preferred creditor treatment (on sovereign exposures)		(48,413)	(73)
Preferential treatment (on FI and corporate exposures)		0	0

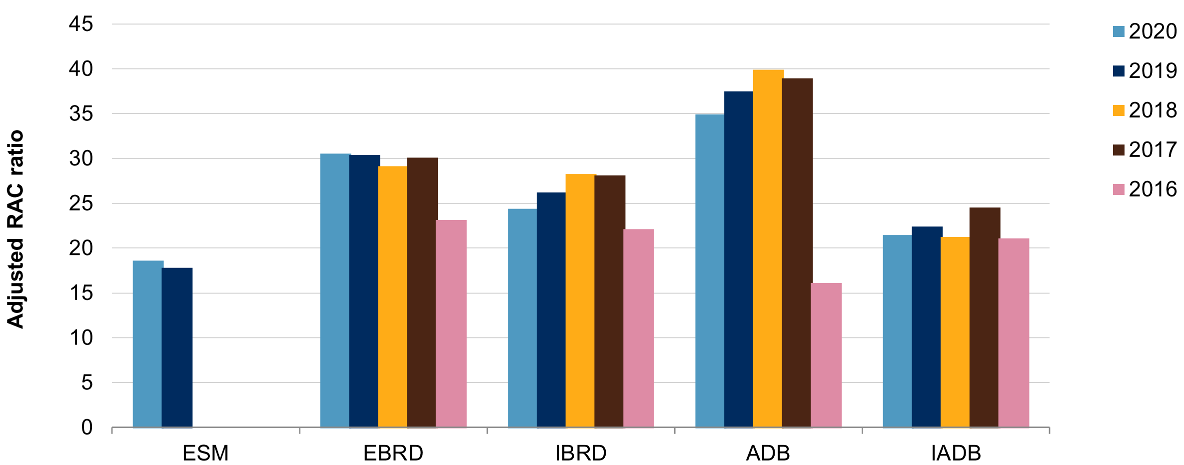
Table 1

European Stability Mechanism Risk-Adjusted Capital Framework* (cont.)		
Single name (on sovereign exposures)	425,689	641
Total MLI adjustments	375,689	495
RWA after MLI adjustments	451,538	595
	Total adjusted capital	**S&P Global Ratings RAC Ratio (%)**
Capital ratio before adjustments	83,580	110.2
Capital ratio after adjustments	83,580	18.5

*As of December 2020. MLI--Multilateral lending institutions. RW--Risk weight. RWA--Risk-weighted assets.

Chart 3

Risk-Adjusted Capital Ratio Peer Comparison



Source: S&P Global Ratings. ESM--European Stability Mechanism. EBRD--European Bank for Reconstruction and Development. IBRD--International Bank for Reconstruction and Development. ADB--Asian Development Bank. IADB--Inter-American Development Bank. RAC--Risk-adjusted capital. N.A.--Not available.

Funding and liquidity

Funding. The ESM is an active benchmark issuer in both euros and, since 2017, U.S. dollars. It has a diversified investor base by type and geography. ESM bonds are eligible for use in repurchase agreements with the ECB and carry a 0% risk weight for banking capital calculation purposes. Total funding volumes in 2020 amounted to €11 billion--in 2021, we expect total funding volumes to be €8 billion, although this could change if any member asks to use the pandemic crisis support credit facility. Although the ESM doesn't have liquidity needs for fresh disbursements at this time, because all lending programs have now concluded, the entity remains an active issuer. Primarily, it issues new debt to roll over existing debt and to maintain its presence in the market in preparation for any unexpected increase in funding levels.

A positive factor in our funding assessment is the ESM's strong structural funding match. Its cumulative assets exceed cumulative debt by 2.1x, for maturities in the next 12 months.

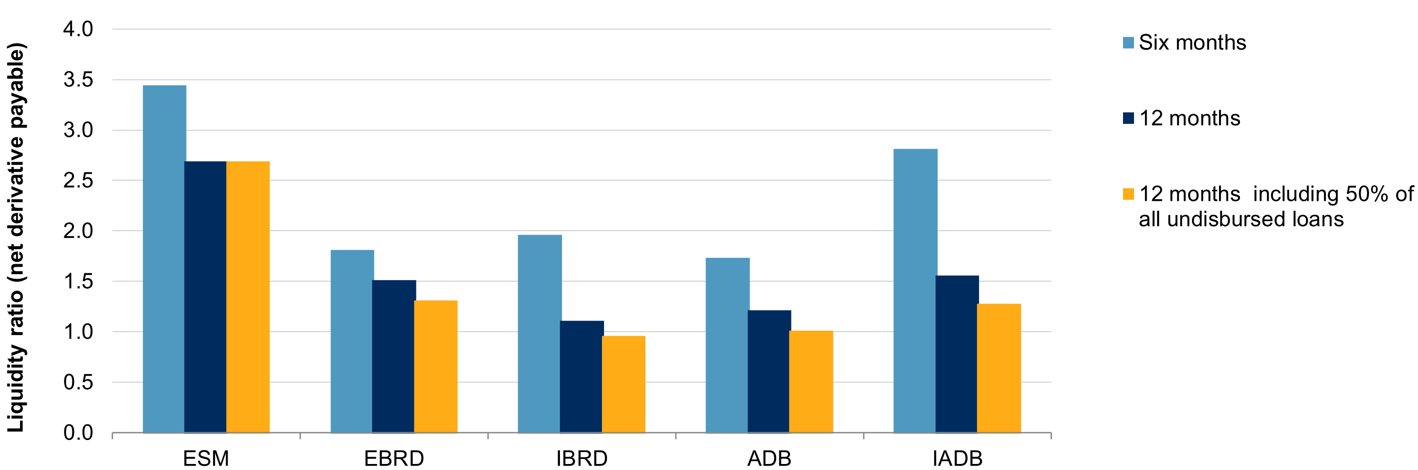
Liquidity. The ESM has ample liquidity, in our view. Our initial assessment is based on its very robust stressed liquidity ratios, which are 3.4x and 2.7x for the next six and 12 months, respectively. This indicates that there is a strong liquid asset coverage of cumulative outflows.

Moreover, the ESM has prudent liquidity policies. Its liquid assets are held in highly rated, fixed-income securities, such as government and local and regional government bonds. In 2020, about 65% of its investments were rated 'AA' or higher by S&P Global Ratings. As part of the ESM's liquidity risk management, its available funds should cover 12 months of liabilities at all times. We project that the ESM is prepared to operate without accessing the market for at least a year, even under stressed conditions.

Under our liquidity assessment, we consider that the ESM would be required to disburse large loans in a short time frame, due to the nature of its activity. We expect the ESM will use its ability to provide disbursements in kind to deliver support quickly. For example, if a large loan is disbursed, the ESM could issue bonds and transfer them to the borrowing member. Such bonds could be used as collateral in repurchase transactions in the market, or with the ECB. For example, the ESM used this approach to recapitalize the Spanish banking sector. We expect that these disbursements-in-kind bonds would be gradually replaced by normal market issuance. Overall, we expect the redemption profile would not jeopardize the ESM's very strong liquidity coverage of the upcoming 12 months of outflows. If it did not maintain strong liquidity coverage, we could reassess its liquidity profile.

Chart 4

Liquidity Stress Test Ratios Peer Comparison



Source: S&P Global Ratings. ESM--European Stability Mechanism. EBRD--European Bank for Reconstruction and Development. IBRD--International Bank for Reconstruction and Development. ADB--Asian Development Bank. IADB--Inter-American Development Bank.

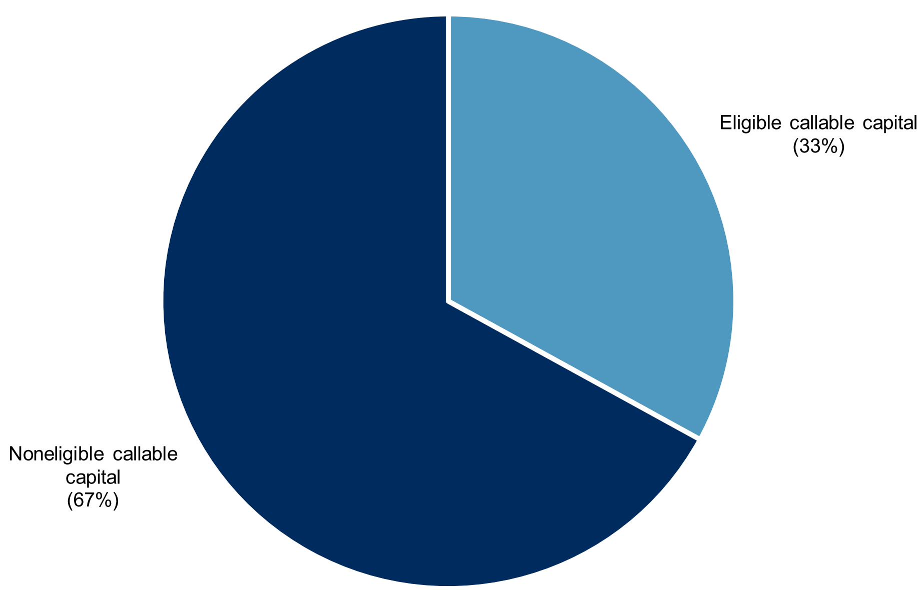
Extraordinary Shareholder Support

The ESM enjoys a large callable capital buffer of €624 billion. This does not directly affect the rating, given that we assess ESM's stand-alone credit profile at 'aaa'. Nevertheless, we acknowledge that, at this time, 33% of the callable capital buffer comes from 'AAA' rated shareholders (Germany, the Netherlands, and Luxembourg).

The ESM benefits from a unique callable capital structure. It has three forms of requesting capital, which in our view limits its financial risks. The ESM's managing director can request that members respond to a capital call within seven days, to avoid any default on an ESM payment obligation to its creditors. Another option would be a capital call to restore the level of paid-in capital, if it needed to preserve its loss absorption, for example. The ESM has a self-imposed capital requirement to maintain a minimum 15% ratio between paid-in capital and outstanding debt, and therefore could ask members to restore its capital levels. Lastly, the ESM could make a "general capital call" if it considered it beneficial to increase its lending capacity. This would have to be approved by the ESM's managing director and board of governors.

Chart 5

Callable Capital
As a percentage of total callable capital



Source: S&P Global Ratings.

Table 2

European Stability Mechanism Selected Indicators

	2020	2019	2018	2017	2016
ENTERPRISE PROFILE					
Policy importance					
Total purpose-related exposure (loans, equity, etc.) (mil. $)	100,979	96,308	91,186	76,564	72,735
Public-sector (including sovereign-guaranteed) loans/purpose-related exposure (%)	100	100	100	100	100
Private-sector loans/purpose-related exposures (%)	0	0	0	0	0
Gross loan growth (%)	4.9	5.6	19.1	5.3	14.3
Preferred creditor treatment ratio (%)	0	0	0	0	0
Governance and management expertise					
Share of votes controlled by eligible borrower member countries (%)	100.0	100.0	100.0	100.0	100.0
Concentration of top two shareholders (%)	47.2	47.2	47.2	47.2	47.2
Eligible callable capital (mil. €)	205,200	205,200	205,200	205,200	205,200
FINANCIAL RISK PROFILE					
Capital and earnings					
RAC ratio (%)	18.5	17.7	N/A	N/A	N/A
Net interest income/average net loans (%)	0.0	0.0	0.0	0.1	0.5
Net income/average shareholders' equity (%)	0.5	0.4	0.3	0.1	0.7
Impaired loans and advances/total loans (%)	0.0	0.0	0.0	0.0	0.0
Liquidity ratios					
Liquid assets/adjusted total assets (%)	50.1	50.4	49.7	55.2	56.6
Liquid assets/gross debt (%)	87.2	89.3	92.3	106.7	111.4
Liquidity coverage ratio (with planned disbursements):					
Six months (net derivate payables) (x)	3.4	3.8	N/A	N/A	N/A
12 months (net derivate payables) (x)	2.7	2.9	N/A	N/A	N/A
12 months (net derivate payables) including 50% of all undisbursed loans (x)	2.7	2.9	N/A	N/A	N/A
Funding ratios					
Gross debt/adjusted total assets (%)	57.5	56.4	53.8	51.7	50.8
Short-term debt (by remaining maturity)/gross debt (%)	28.1	27.8	21.3	27.9	21.2
Static funding gap (with planned disbursements)					
12 months (net derivate payables) (x)	2.1	2.3	N/A	N/A	N/A
SUMMARY BALANCE SHEET					
Total assets (mil. $)	204,353	195,721	182,800	172,568	168,576
Total liabilities (mil. $)	119,859	112,092	99,828	90,032	86,134
Shareholders' equity (mil. $)	84,493	83,629	82,972	82,537	82,442

Source: S&P Global Ratings. RAC--Risk-adjusted capital. N/A--Not applicable.

Table 3

European Stability Mechanism Peer Comparison

	European Stability Mechanism	European Bank for Reconstruction and Development	International Bank for Reconstruction and Development	Asian Development Bank	Inter-American Development Bank
Issuer credit ratings	AAA/Stable/A-1+	AAA/Stable/A-1+	AAA/Stable/A-1+	AAA/Stable/A-1+	AAA/Stable/A-1+
Total purpose-related exposure (mil.$)					
Preferred creditor treatment ratio (%)	0.0	0.0	0.2	0.2	2.0
Risk adjusted capital ratio (%)	18.5	30.4	24.3	34.8	21.3
Liquidity ratio 12 months (net derivative payables; %)	2.7	1.5	1.1	1.2	1.6
Funding gap 12 months (net derivative payables; %)	2.1	1.9	1.3	1.1	1.5

Source: S&P Global Ratings.

Ratings Score Snapshot

Enterprise Risk Profile	**Extremely strong**	Very strong	Strong	Adequate	Moderate	Weak	Very weak
Policy Importance	**Very strong**	Strong	Adequate	Moderate	Weak		
Governance and Management	**Strong**	Adequate	Weak				
Financial Risk Profile	**Extremely strong**	Very strong	Strong	Adequate	Moderate	Weak	Very weak
Capital Adequacy	Extremely strong	**Very strong**	Strong	Adequate	Moderate	Weak	Very weak
Funding and Liquidity	**Very strong**	Strong	Adequate	Moderate	Weak	Very weak	

Related Criteria

- Criteria | Governments | General: Multilateral Lending Institutions And Other Supranational Institutions Ratings Methodology, Dec. 14, 2018

- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Abridged Supranationals Interim Edition 2021: Comparative Data For Multilateral Lending Institutions, May 11, 2021
- European Financial Stability Facility, April 26, 2021
- Greece Upgraded To 'BB' On Improved Governance Effectiveness; Outlook Positive, April 23, 2021
- European Central Bank, March 31, 2021
- Spain 'A/A-1' Ratings Affirmed; Outlook Remains Negative On Fiscal And Structural Challenges, March 19, 2021
- Cyprus 'BBB-/A-3' Ratings Affirmed; Outlook Stable, March 6, 2021
- Supranationals Special Edition 2020 Says Multilateral Lenders Are Addressing Challenges From COVID-19, Oct. 21, 2020
- Supranationals Edition 2020: Comparative Data For Multilateral Lending Institutions, Oct. 21, 2020
- Introduction To Supranationals Special Edition 2020, Oct. 20, 2020
- How Multilateral Lending Institutions Are Responding To The COVID-19 Pandemic, June 9, 2020
- Can Multilateral Lenders' Capital Bases Hold Up Against COVID-19?, June 9, 2020
- ESG Industry Report Card: Supranationals, Feb. 11, 2020

Ratings Detail (As Of August 9, 2021)*		
European Stability Mechanism		
Issuer Credit Rating		
Foreign Currency		AAA/Stable/A-1+
Senior Unsecured		AAA
Issuer Credit Ratings History		
13-Aug-2020	*Foreign Currency*	AAA/Stable/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.