

SAFEGUARDING THE EURO IN TIMES OF CRISIS

The inside story of the ESM



European Stability Mechanism



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Luxembourg: Publications Office of the European Union, 2019

Print	ISBN 978-92-95085-34-3	doi:10.2852/47298	DW-06-16-056-EN-C
PDF	ISBN 978-92-95085-33-6	doi:10.2852/788601	DW-06-16-056-EN-N

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Acknowledgements

It was at a weekly ESM management board meeting some years ago that the idea first emerged to write the story of the rescue funds. Our story is deeply intertwined with that of the euro crisis, and it therefore provides some important chapters in the history of the euro, whose 20-year anniversary we are celebrating this year. Since the rescue funds were created only recently, all the key players were still available to recount their part in the story. With this in mind, we interviewed many of those who contributed to setting up the temporary EFSF and permanent ESM so the tale could be told by those who first envisaged and then built the institutions.

We are deeply indebted to those who took the time to share their memories with us. They all played a role in shaping the euro area's response to the crisis: as finance ministers, leaders and representatives of institutions, and programme country experts. We would like to thank those who spoke with us: Maria Luís Albuquerque, Benjamin Angel, Marco Buti, Alfred Camilleri, Kevin Cardiff, Mitsuhiro Furusawa, Vítor Gaspar, Timothy Geithner, Vittorio Grilli, Georges Heinrich, Deborah Henderson, Christine Lagarde, John Lipsky, David Lipton, George Papaconstantinou, Olli Rehn, Michael Sarris, Wolfgang Schäuble, Yannis Stournaras, Fernando Teixeira dos Santos, Jean-Claude Trichet, Euclid Tsakalotos, Maarten Verwey, Thomas Weinberg, and Thomas Wieser. We would also like to thank those who provided written comments: Mário Centeno, Jeroen Dijsselbloem, Luis de Guindos, Mario Draghi, Jean-Claude Juncker, and Peter Kažimír.

But we could not have chronicled the creation of the institution without the first-hand accounts of those who were on the inside from day one, especially Klaus Regling, ESM managing director and the founder of the rescue funds. Chief Economist Rolf Strauch, Deputy Managing Director and Chief Finance Officer Christophe Frankel, and Secretary General Kalin Anev Janse were among the first to join Regling, as were a number of ESM colleagues from the various divisions and departments, from junior to senior level, many of whose voices you will hear throughout this book. A number of ESM colleagues were

also later involved in the daunting task of reviewing several drafts of the book and annexes, as well as contributing expert material. Without their admirable efforts, this book could not have been written.

We were fortunate to have Rebecca Christie as our lead author for this book. A former Bloomberg reporter in Brussels, she covered the crisis and its aftermath until 2016 when she established herself as an independent writer. We owe a great deal to her profound background knowledge, quick grasp of new information, compelling writing style, and ability to work under immense time pressure.

Special thanks go to Thomas Wieser, President of the Eurogroup Working Group until early 2018, who reviewed the final book manuscript and provided extremely valuable comments.

Safeguarding the euro in times of crisis: The inside story of the ESM could not have been published in its final form without the invaluable support of the Publications Office of the European Union in Luxembourg and its very dedicated staff. We are very grateful for their work on this book, their advice, and assistance. We would also like to thank Emma Vandore and James Neuger, whose expertise helped to transform this project into reality.

Most big undertakings have unsung heroes. For this publication there are two: one is Sharman Esarey, the ESM's principal editor. Without her outstanding talent as an editor and her exceptional social skills there would simply not have been such a book. The same is true for Assistant Editor Rachel Calero. Her unparalleled organisational skills and her friendly insistence on deadlines and deliveries brought structure to a process that sometimes seemed too complex to master.



ESM management board

Credit: Steve Eastwood/ESM

Foreword by
Jean-Claude Juncker,
President of the European Commission

At 20 years young, the euro has already come a long way. A generation ago, it would have been unthinkable for 340 million Europeans in 19 countries to share a currency.

Our single currency has always been more than the notes and coins in our pockets and wallets. It is the symbol of unity and the promise of prosperity and protection. It allows us to enjoy stable prices, lower transaction costs, protected savings, more transparent markets and increased trade. It creates jobs at home and gives Europe more influence in an increasingly competitive world.

It was not always easy – quite the opposite. As someone who was there from the start, I witnessed the ups, downs, and teething problems that our Economic and Monetary Union went through. The financial crisis that started in 2007 did not originate in Europe, but it hit us harder than any other event since World War II. Jobs were lost, economies shrank, and confidence was shaken.

Europe learned some hard lessons – and it had to act decisively to put right what had been exposed as being insufficient. Euro area countries had to stand up to better protect Europeans and their currency. Emergency measures were taken to provide new financial safeguards and support the countries most affected.

As the president of the Eurogroup at the time, I was among the policymakers who decided to set up the European Financial Stability Facility (EFSF) and I was happy that we were able to recruit Klaus Regling to lead it. The EFSF and its permanent successor, the European Stability Mechanism (ESM), have played a decisive role in the stability of the euro area by serving as our firewall and supporting member states to regain or maintain access to sovereign bond markets. Let me pay tribute to all the ESM staff who contributed.

Thanks to the efforts of Europeans and resolute action at national and EU levels, the situation has turned: Europe's economy has moved from recovery to expansion and unemployment is at record lows. Growth has spread to every part of Europe and more people are in work than ever before. Confidence and investment have returned. This shows that Europe is able to move forward when there is political will, unity, and determination. It is little wonder that popular support for the euro is now at record levels.

Having said this, the crisis has had a far-reaching impact, and there is always a risk of downturns on the horizon, so there should be no room for complacency. While we have made important reforms in recent years, we must get on with the job of completing Europe's Economic and Monetary Union and equipping our single currency with the tools it needs to thrive.

As we look to the next chapter in the story of the euro, I believe the ESM should naturally graduate into a robust crisis management body, to be incorporated into EU law alongside other institutions. Having seen it grow since day one – and having worked closely with Klaus Regling and his team – I know that it will be more than up to the task.

Foreword by
Klaus Regling,
ESM Managing Director

'Europe will not be made all at once, or according to a single plan. It will be built through concrete achievement.'

Declaration by French Foreign Minister **Robert Schuman**, 9 May 1950

It took a half century after Schuman's generation embarked on the project of European integration for one of the most concrete achievements of all, the single currency, to become reality. This year, we mark both the 20th anniversary of the start of Economic and Monetary Union in 1999 and the 10th anniversary of the first signs of financial tumult in Greece in 2009 and the onset of the euro crisis.

In the policy response to the crisis, there were traces of Schuman's thinking. As the financial and economic crisis spread from Greece to Ireland, Portugal, Spain, and eventually Cyprus, European leaders acted in the spirit of incremental progress – with a healthy dose of improvisation – that animated the post-World War II generation. It was a matter of providing rapid, conditional relief for financially impaired governments while building institutions to make the euro area more robust and less vulnerable over the longer term.

Europe's rescue funds – the temporary European Financial Stability Facility (EFSF) and its permanent successor, the European Stability Mechanism (ESM) – were one of the products of the deliberations, often into the wee hours of the morning, of policymakers confronted with this unprecedented challenge. This book is the story of the EFSF and ESM, from the high-stake summits and Eurogroup meetings and endless technical and brainstorming sessions to the design and creation of a new international financial institution, built from scratch through the recruitment of professional staff, renting of office space, and setting up of systems.

The EFSF and ESM grew up in the heat of the crisis, scrutinised by nervous financial markets, a worried public, and concerned euro area country governments. Unsurprisingly, the rescue funds didn't emerge in their mature form overnight. The EFSF's guarantee-based financing structure was the imperfect product of compromise, and when it began operations in mid-2010, its sole ambition was to lend to distressed governments. Over time, the EFSF was equipped with additional tools. These instruments were later transferred to the ESM, which rests on a sturdier, capital-backed foundation.

What pulled the monetary union back from the precipice was, ultimately, the willingness of the people of programme countries to support difficult policy choices for the sake of a better future, and the solidarity of the other member states of the euro area, even amid fierce domestic debate. But this account would be incomplete without the women and men of the EFSF and ESM. This is their history, too: how an international financial organisation, rooted in banking and the markets yet infused with a clear public sector mission, became an essential part of the euro area architecture over a few short years.

This chronicle embeds the story of the two rescue mechanisms in the broader history of the crisis, drawing on first-hand insights from interviews with all the main actors, among them political leaders, finance ministers, and central bankers. It takes the reader inside the critical discussions, from Athens to Berlin, Dublin to Brussels, Washington DC, to Luxembourg – and many places in between. Restoring stability to the euro required hard work on multiple fronts, but one lesson that resonates in these pages is that everyone was working towards an identical goal: defending the currency, one step at a time.

The period between 2010, when the first rescue fund was established, and 2018, when Greece became the last country to successfully exit its financial programme, was a defining phase in the history of European integration. I believe this will become increasingly clear as this period retreats into the past and is studied in greater detail by journalists, scholars, and the general public. I hope this book will be an informative contribution.

Defending a symbol: 'the euro is here to stay'

1

The creation of the EFSF and ESM was thanks to an unprecedented show of political will and innovation.

Jean-Claude Juncker

President of the European Commission (since November 2014), inaugural Chairman of the ESM's Board of Governors (October 2012–January 2013) and President of the Eurogroup (January 2004–January 2013)

In the first few years after its 1999 debut, the euro symbolised what the euro area member states had achieved together. Citizens could work, shop, and save across borders without having to convert their money into francs and marks. Enterprises could do business across all countries that used the euro without experiencing any exchange rate risk, and capital markets benefited from a larger pool of securities denominated in the same currency. Over time, markets began to trade euro area sovereign bonds more interchangeably.

Ten years later, global financial turmoil caused tremors that would shake the new currency to its core. By 2010, the crisis that erupted in the United States (US) had triggered a sovereign debt crisis in Europe. Investors began to wonder if the groundbreaking common currency could withstand the rising debts and troubled banks that were plaguing several of its countries and threatening the rest. As doubts spread, conservative bond investors grew increasingly nervous and pressed

ever lower the prices at which they were willing to buy the sovereign debt of some euro countries. This forced up the interest rates on that debt to levels that crippled national budgets.

To meet this challenge, the euro area erected a firewall. Beginning with the European Financial Stability Facility (EFSF) and continuing with its permanent successor, the European Stability Mechanism (ESM), the countries that joined forces to build the euro made it clear that they would stand together.

This collective action meant that during the worst of the crisis, the EFSF and ESM were able to tap financial markets to provide rescue funding to five of the euro area's 19 member states. Because of this steady access to affordable financing amid the broader market turmoil, those five countries were able to undertake the reforms they needed to compete and thrive in the global economy. Moreover, thanks to the innovative way the firewalls were structured, the rescue programmes were financed with minimal risk and virtually no direct cost to taxpayers elsewhere in the currency union.

For Jean-Claude Juncker, who during the first years of the crisis was premier of Luxembourg and also led the finance ministers of the Eurogroup, the currency area has emerged stronger than ever. The euro was under serious threat when the sovereign debt crisis reached its peak in 2011 and 2012. At that moment, various doomsayers predicted the end of the single currency. 'They were proven wrong,' said Juncker, now president of the European Commission. 'The euro is here to stay.'

Historically, as part of the European Union's (EU's) founding treaties, fiscal policies were left up to each individual Member State. The euro area had adopted budget guidelines, known as the stability and growth pact, to try to keep all of its member states on the same page when it came to borrowing and spending. But those agreements had not held up in times of economic struggle. Germany and France had led a push in 2003 to avoid sanctions for their own higher deficits¹, and in their shadow it was easy for other countries to postpone the fiscal day of reckoning. As long as bond yields stayed uniformly low across the region, there had been no pressing need to address the flouting of the budget rules.

All links were checked and worked correctly on 3 April 2019.

¹ *Guardian* (2003), 'France and Germany evade deficit fines', 25 November 2003. <https://www.theguardian.com/business/2003/nov/25/theeuro.politics>

Everything was made worse by the crisis that hit the world in 2007 and 2008 after convulsions in the US financial system. Governments worldwide were under huge pressure as the worst recession since the 1930s shrank tax revenues and boosted welfare spending. The Group of 20 and the EU decided collectively to undertake expansionary fiscal actions in response. The subprime mortgage crisis, in which lenders around the globe took on too much exposure to risky US housing loans, also exposed huge flaws in the banking system. Countries were forced further into the red by providing recapitalisation to troubled banks. As a result, government balance sheets deteriorated and nervous investors looked for weaknesses. This pattern would repeat itself throughout the five years when the euro crisis was at its most threatening.

In 2009, the market's unfettered confidence abruptly evaporated after Greece elected a new government that came face to face with far higher budget deficits than had been reported. For too long, markets had ignored growing disparities in the economic fundamentals of euro area countries. When the true level of the Greek debt and deficit was revealed, investors overreacted in the opposite direction, withdrawing capital by selling off debt not only from Greece but also from countries across the region.

Some countries, such as Ireland, had independently run into trouble because of a bursting real estate bubble and subsequent difficulties in the banking sector. Others, such as Portugal, were in 2009 already up against the limits of what they could sustainably borrow following worsening current account imbalances. Throughout the currency area, the onslaught of uncertainty radiated from Greece to nearly every euro country active in the sovereign debt markets.

In the euro area's first years, the economic success of its strongest nations had spread throughout Europe. Now the trend was running the other way. Countries that had been seen as healthy lost the benefit of the doubt, while those that were facing challenges saw their tribulations increase almost overnight. This cycle of contagion, as trouble spread from one hotspot to another, meant the euro area was at risk of losing the longstanding ability of all its members to raise money on financial markets. The implications ranged from higher borrowing rates to a possible total loss of market access that would leave governments unable to raise funds.

For example, after Greece's deficits came to light, new questions arose about Ireland, whose government had promised to guarantee² all bank debts in a bid to head off what had previously appeared to be a self-contained financial shock.

Difficulties in one country showed up in another as the crisis got worse. In January 2012, the credit-rating agency Standard & Poor's highlighted the extent of the damage by downgrading nine euro area countries, including two countries previously AAA rated: France and Austria³.

The euro area was vulnerable to these kinds of shocks because of the way its member states had bound themselves together. Often a financial crisis is followed by large currency movements, driven by the markets when investors perceive a risk of investing in a country's currency, or driven by a decision by governments to devalue their currency. For euro area countries, this was not possible to do on a country-by-country basis.

Once Europe's greatest symbol of post-World War II unity, the common currency was under threat. In the years to come, the euro area would repeatedly be called upon to prove its mettle.

There was no mechanism to help distressed countries within the currency union before the global crisis hit. As conditions deteriorated, investors began to ask what would happen if governments ran out of money and couldn't borrow more. What if Greece defaulted on its debts, and what if that in turn shut other countries out of financial markets so that they, too, would default? They feared Greece's exit from the euro – Grexit – and the financial turmoil that could force others out. This pressure spread across the entire region.

Policymakers across Europe fretted about how to stop the shockwaves from Greece, in order to avoid fracturing the euro area. But the contagion was already taking root.

'The fear of hanging sharpens a person's mind,' said Thomas Wieser, who throughout the crisis was chairman of the Eurogroup Working Group and the Economic and Financial Committee, the two most

² Ireland, Houses of the Oireachtas (2008), Credit Institutions (Financial Support) Act 2008, 2 October 2008. <https://www.oireachtas.ie/en/bills/bill/2008/45/>

³ *Financial Times* (2012), 'S&P downgrades France and Austria', 14 January 2012. <https://www.ft.com/content/78bf6fb4-3df6-11e1-91f3-00144feabd0>

important economic committees of the euro area and the EU. In the Eurogroup Working Group, the euro area’s finance ministry deputies’ group, Wieser steered the detailed financial planning for the country programme rescues until he retired in January 2018. He put the euro’s problem succinctly: ‘When the Greek crisis struck, we had no instrument to tackle it – and specifically the contagion that concerned us all at the time.’

The common currency area was at a crossroads: would its leaders provide a safety net to defend the euro, or would they allow it to splinter into pieces? They had to find the will to act. ‘It had become apparent that we needed something to stabilise the euro,’ Wolfgang Schäuble, Germany’s former finance minister, said. ‘We had to take consistent and resolute action to shore up the euro area’s financial stability.’

Euro area leaders sought assistance from the international financial system’s lender of last resort, the International Monetary Fund (IMF), but never depended upon it entirely. Because of the unique interconnections at the heart of monetary union, the euro area needed its own backstop alongside the IMF’s global prowess. Moreover, the IMF’s lending capacity would not have allowed it to provide all the money needed by those euro area countries that lost market access over the course of the crisis.

‘We needed to create our own European funds,’ said Klaus Regling, the EFSF’s chief executive and the ESM’s inaugural, and to date only, managing director.

At the height of the crisis, Europe’s politics were divided among countries that needed aid, those that might, and those that did not think they ever would. The founding treaties of the EU barred the assumption of a country’s debts by another country or by the EU, and there were no tools immediately available for providing a helping hand on the scale needed.

Against this backdrop, the euro area moved to tackle the financial crisis in a stepwise fashion. At every stage, member states pushed the boundaries of what was then politically possible, so that each move would be stronger than its precursor. The firewall that emerged would be a fundamentally European solution.

In 2010, the first initiative was a bilateral loan programme for Greece, collectively managed by the Commission and named the Greek Loan Facility⁴.

‘To avoid contagion to other members of the currency union, we quickly needed to come up with a convincing approach that could also be implemented in the short term,’ Schäuble said. ‘We knew that these solutions were only temporary and that we needed to work on creating a permanent crisis mechanism, which is where the ESM eventually came in.’

The first breakthrough came during a fateful weekend in May 2010, when the euro area worked round the clock to put together a crisis response to keep the monetary union together. Directed by European leaders, and backed by ECB, the European Commission, and the IMF, euro area finance ministers strove to find a solution that would calm financial markets: a fund able to borrow on global capital markets in order to lend to nations that could no longer borrow on their own.

The stakes were enormous, remembered Christine Lagarde, who was then France’s finance minister and would later become IMF managing director. ‘If we could not reach agreement, there would be no firewall and the crisis would spread to the point where the euro was under threat.’

That weekend gave birth to the temporary EFSF, which in turn was a bridge to the permanent ESM in terms of concept and politics. The interim fund, which became fully operational in August 2010 and issued its first bond in January 2011, had an immediate ability to tap financial markets at affordable rates, replacing the stopgap system of bilateral loans that had failed to contain the contagion. In just seven months, the EFSF went from a sketch on paper to a fully fledged, top-rated issuer in capital markets.

The EFSF was backed by guarantees provided by its Members. At the time, that system was what made it attractive because it was a way around writing an upfront cheque, Wieser said.

The EFSF was also designed to be temporary, and initially its aid loans were priced at a steep premium to typical market rates for stable countries. When a euro area rescue fund had first been floated, sceptics

⁴ European Commission, Directorate-General for Economic and Financial Affairs (2010), ‘The Economic Adjustment Programme for Greece’, *European Economy Occasional Papers* 61, May 2010. http://ec.europa.eu/economy_finance/publications/occasional_paper/2010/pdf/ocp61_en.pdf

had sought to limit its availability so it wouldn't be over-relied upon. Euro area member states were understandably reluctant to provide funds to other countries for a lengthy period. At the same time, the fund proved essential in fighting back against euro area contagion. The EFSF's success set the stage for its permanent successor, as the euro area became more comfortable with new ways of working together to help a country get back on its feet.

As a permanent institution backed by a buffer of paid-in capital, the ESM took things to a new level when it began operations in October 2012. It offered a sturdier financing framework than the EFSF, which allowed it to respond faster to countries in need. The ESM, set up outside the EU treaties, has not only mobilised large amounts of money in markets, but it has also been a source of technical and practical advice to euro area member states in times of deep financial strain.

‘The EFSF, and later the ESM, were crucial tools for dealing with the sovereign debt crisis in the euro area,’ said Mario Draghi, president of the European Central Bank (ECB) since November 2011.

Operating with a single staff and office since the ESM's 2012 inception, the two funds stood for action during a time when some feared the bloc that had taken so long to build could be ripped apart overnight.

Timothy Geithner, former US Treasury secretary, said the crisis worsened in part because of ‘an external perception that Europe was not willing to put the resources’ into the type of policy response that was needed. The evolution of the ESM, along with parallel moves towards euro area banking union and stronger financial regulation, helped put these global fears to rest.

Moving to a permanent euro area institution was of ‘paramount importance,’ Alfred Camilleri, permanent secretary for budget and finance in the Maltese finance ministry, said. ‘There was a very strong suspicion that contagion would escalate, and that a number of other countries – especially those that were significantly more vulnerable – would be hit,’ he said. ‘Policy is often formulated and implemented in response to particular situations. The euro area is still a work in progress. These two institutions were created in response to, and in the context of, a crisis.’

Overall, the two firewall funds were called on to assist first Ireland, and then Portugal, Greece, Spain, and Cyprus. In every case, the euro area made clear that its assistance would come in the form of loans,

not grants, and that countries would be required to strengthen their economies in return through macroeconomic, structural, and financial sector reforms, referred to as ‘conditionality’. That meant reining in debt, opening up internal markets, and taking action to regain competitiveness. Each loan came conditional upon specific reform requirements, including timetables for their enactment.

‘We don’t make any disbursements without conditionality. One can argue what is the best conditionality, but it’s always tough,’ Regling said.

Regling was Juncker’s choice to lead the firewall from the beginning. The then-chief of the Eurogroup sought to tap into Regling’s experience at the German finance ministry, the IMF, and the Commission, as well as in the private sector. After such a career tour, with both policy experience and technical expertise, Regling was primed to shepherd a new institution at the intersection of governments and markets. His expertise was an essential part of the push to avoid the ‘grave danger’ posed by the euro area’s struggles and the threat of a worsening worldwide crisis, said Mitsuhiro Furusawa, former vice minister at the Japanese finance ministry and now deputy managing director at the IMF.

‘No one had any doubt when he was chosen to lead the EFSF and the ESM,’ Furusawa said. ‘He was a faithful advocate of a strong euro area, and he has a lot of credibility in the international financial community.’

The euro’s firewall funds were set up in Luxembourg, well regarded for its corporate statutes and recognised as a financial centre. Already home to EU institutions such as the European Investment Bank (EIB) and the Court of Justice of the European Union, the Grand Duchy welcomed the EFSF and provided its start-up funds and its first – and, for one month, sole – director, Georges Heinrich. Then treasurer-general at Luxembourg’s finance ministry, he said there was never any question whether or not Luxembourg would lend its support to its peers as the crisis erupted.

In short order, the firewalls went from being bond market unknowns to reliable and extensive issuers of euro-denominated securities, and in 2017 the ESM completed its first non-euro bond sale in dollars. With issuance ranging from short-term bills to very long-term bonds, the rescue funds have together proven their ability to work with investors and programme countries to ensure that there is always ready market access for the euro region.

The ESM’s solid capital structure is the lynchpin of this financial security. The ESM holds over €80 billion in paid-in capital – far more than any other international financial institution – and has the possibility of calling up an additional €624 billion from its Members, the euro area member states. Building this capital base was a huge achievement for the currency union, where there has always been strong political resistance to creating a common borrowing authority that would have joint liability for all funds raised.

In October 2017, the ESM marked its fifth anniversary. From the outset, Regling sought to create an institution that emulated the best qualities of its many influences, without becoming hidebound to a single tradition. The staff of the firewall was drawn not only from the familiar hunting grounds of central banks, finance ministries, and international institutions, but also from private sector investment banks and technology companies. With a total workforce now of under 200, the ESM has consciously created lean and flexible structures, while also translating that culture into a public service mission befitting an international financial institution.

‘We didn’t have any template to look at. Everything we’re doing here we had to build from scratch,’ said Cosimo Pacciani, the ESM’s chief risk officer.

Up until 2015, the ESM was a true start-up. This is no longer the case, said Jeroen Dijsselbloem, former Dutch finance minister, who was Eurogroup president and chairman of the ESM Board of Governors through the later part of the crisis. ‘With its upgraded risk framework, its robust internal controls, its early warning system, its programme evaluation, and its staffing, the ESM is now a fully mature institution,’ he said.

One by one, the five countries that received aid have exited their rescue programmes and returned to affordable market access. Each remains in close contact with the ESM through the firewall’s early warning system, so that any future financial difficulties can be identified and addressed early on. Most recently, in August 2018, Greece exited its ESM programme, after far-reaching macroeconomic, financial, and structural reforms.

There are three major lessons to be learned from the euro’s trials, said the IMF’s Lagarde. First, it is crucial to move quickly – both in raising the alarm and in providing a remedy – to identify when trouble is brewing and get started on solutions early on. Second, the countries

that are in the toughest spots need to take political ownership of the reforms necessary to get their economies back on track. Third, it's critical to have the right data – the case of Greece in particular shows that, when economic statistics aren't accurate, the fallout can be devastating⁵. The ESM's arrival is emblematic of the euro area's advances in these areas, and of its commitment to combat future crises and sustain its single currency.

With the ESM, the euro has emerged strengthened from what could have been its undoing. Question marks about the euro area's willingness and ability to act have been put to rest. This book is a reflection of that journey, of the lessons learned along the way, and of Europe's historic show of solidarity during a time of great crisis.

⁵ *Financial Times* (2010), 'Greece condemned for falsifying data', 12 January 2010. <https://www.ft.com/content/33b0a48c-f7e-11de-8f53-00144feabdc0>

Lurching towards crisis: a 'very fragile' world

2

The idea that we had a systemic problem was there. The Greek loss of competitiveness was not that different from the Irish loss of competitiveness.

Jean-Claude Trichet

ECB President (November 2003–October 2011)

When the euro area made its historic decision to create a common firewall, it had been buffeted by two major crises, each of which had been building for years. First, Europe was sent reeling by the US subprime mortgage debacle and the shockwaves caused by the collapse of the investment bank Lehman Brothers in 2008. This fed into a second crisis, when the euro area was forced to deal with its heavy sovereign debt load as well as real estate bubbles in some member states, amid unprecedented turmoil in the markets.

Alarm bells started ringing in the euro area as soon as the subprime mortgage market storm began to brew in the US, said Vítor Gaspar, former Portuguese finance minister and now head of the IMF's fiscal affairs department. From 2007 to 2010, Gaspar led the European Commission's in-house economic policy think tank, the Bureau of European Policy Advisers.

‘When the global financial crisis started in the summer of 2007, my main concern was: what if the turmoil in financial markets, given the fragility of some financial institutions, migrates to the sovereign?’ Gaspar said. ‘My perception at the time was that Europe did not have the institutional infrastructure to manage this. It was a vague fear at that point, but it became increasingly more pressing.’

Fallout from the subprime collapse spread quickly across the Atlantic. The US investment bank Bear Stearns liquidated two of its hedge funds on 31 July 2007, and in early August the French bank BNP Paribas halted redemptions on three investment funds. In September, the Bank of England stepped in to support Northern Rock⁶, the UK’s fifth-largest mortgage lender. By February 2008, Northern Rock had to be nationalised, and in March the US moved to shore up Bear Stearns with a bridge loan and helped it merge with JPMorgan Chase.

In the following months, the flames of the US crisis would rise to new heights. The mortgage giants Fannie Mae and Freddie Mac ran into trouble and were nationalised in September 2008. A week later, Lehman Brothers filed for bankruptcy. Its failure was a calculated move to let market forces act in place of taxpayer bailouts, but the explosive strength of the market reaction caught policymakers off guard in the US and around the world. The US had to backpedal immediately, offering government support to the insurance giant AIG, and then to a large swathe of its biggest financial institutions via the Troubled Asset Relief Program⁷.

A series of crises tumbled over one another even before the troubles in Greece erupted, prompting Europe’s sovereign debt problems, according to Wieser, former chairman of the Eurogroup Working Group. ‘Lehman did not lead to the Greek crisis; Lehman led to a succession of five or six crises before it morphed into the Greek crisis.’

The euro area faced its own challenges. Because countries shared an exchange rate and a central banking system, those that had lost competitiveness couldn’t devalue their currencies, and economic conditions were more likely to deteriorate. The most direct way

⁶ United Kingdom, National Audit Office (2009), *HM Treasury: The nationalisation of Northern Rock*, Report by Comptroller and Auditor General (HC: 298 2008-09), 20 March 2009. <https://www.nao.org.uk/wp-content/uploads/2009/03/0809298es.pdf>

⁷ US, Department of the Treasury (2016), ‘TARP programs’, 15 November 2016. <https://www.treasury.gov/initiatives/financial-stability/TARP-Programs/Pages/default.aspx>

authorities in a monetary union can respond to growing imbalances between countries is to cut wages, salaries, and pensions, in what is known as an 'internal devaluation'. Understandably, this isn't popular with voters.

'We can blame the US for the first crisis. That's where it was triggered. But the second crisis was our own problem,' said Regling, ESM Managing Director. 'Problems accumulated for more than a decade, with countries losing competitiveness because they increased their wages and salaries too quickly, more than productivity gains allowed. Some ran overly large fiscal deficits so their debt was too high, while others experienced huge real estate bubbles.'

When times were good, euro area member states had little incentive to curb bubbles that were propelling growth because of the generous borrowing conditions enjoyed by every country in the bloc.

'The euro, in a way, allowed these imbalances to get bigger than they would have become otherwise,' Regling said. 'The view that was out there was that financing would always be automatic, whatever the current account situation.'

For years, banks had invested heavily in euro area government bonds because the perceived risk of sovereign default was low. When investors began to question this logic, large exposures to sovereign debt already tied banks and governments together – and the bank-sovereign link was set to tighten further. Not only could banks founder by investing too heavily in sovereign debt, but governments suffered if they had to rescue struggling banks. During the boom years, banks across the euro area offered easy credit to homebuyers and business owners, only to later discover those loans might not be repaid.

As September drew to a close, the Benelux bank Fortis was seeking taxpayer help, soon followed by Dexia, Royal Bank of Scotland, HBOS, and Lloyds TSB. The costs of handling multiple banking emergencies would add to an already difficult fiscal and economic environment for many European countries. Towards the end of 2008, the euro area entered a deep recession⁸ that would last for five consecutive quarters.

⁸ *Independent* (2008), 'Eurozone enters recession', 14 November 2008.
<https://www.independent.co.uk/news/business/news/eurozone-enters-recession-1018629.html>

In Ireland, the banking sector was headed towards systemic collapse. In addition to low interest rates and a roaring real estate market, Ireland had experimented with banking oversight changes that didn't keep close enough tabs on what the banks were up to. The supervisors not only failed to rein the banks in soon enough; they also didn't have sufficient information to act.

The day after Fortis sought aid, Ireland announced a blanket two-year guarantee for its banks in the hope of reassuring investors that the banks would not default. But the gambit would not succeed. The Irish government later forced fresh capital into two of its biggest banks and nationalised a third. The moves illustrated the challenge of trying to protect both the economy and financial stability. Ireland would become the first euro area country to succumb to the bank-sovereign doom loop: the cross-contamination between bank balance sheets and government finances would push the euro area to its limits.

On the one hand, Ireland set a dangerous precedent by merging its bank debts with its national finances. On the other, the country was under tremendous pressure to protect senior investors in bank debt, who in Europe had historically been shielded from losses. At a summit held in October 2008, euro area leaders pledged to consider coordinated guarantees of senior bank debt for up to five years as part of a 'concerted European action plan' in response to the crisis⁹.

Regling, at the time a consultant in the private sector, and the economist Max Watson, a former senior staff member at the IMF and the Commission, were tasked with assessing the Irish banking crisis in its aftermath. 'In euro area members, fiscal and prudential policies must take into account, and seek to mitigate, a mismatch between monetary conditions and the national business cycle,' they wrote in *A preliminary report on the sources of Ireland's banking crisis*¹⁰. This was particularly important during the transition to the common currency, as several countries shifted from their traditionally higher interest rate levels to the lower rates prevailing in the euro area. Lacking proper oversight, banks faced a huge temptation to make far too many risky loans.

⁹ Summit of the euro area countries – Declaration on a concerted European action plan of the euro area countries, No. 14239/08, 14 October 2008.

<http://register.consilium.europa.eu/doc/srv?l=EN&f=ST%2014239%202008%20INIT>

¹⁰ Regling, K., Watson, M. (2010), *A preliminary report on the sources of Ireland's banking crisis*, p. 43, Government Publications Office, Dublin.

<http://www.bankinginquiry.gov.ie/Preliminary%20Report%20into%20Ireland%27s%20Banking%20Crisis%2031%20May%202010.pdf>

Regling and Watson's advice to Ireland held for the euro area in general, and underscored the importance of healthy banks to a healthy economy. Banking difficulties would be a central component of every assistance package the euro area considered, taking centre stage in Spain and Cyprus and playing significant roles in Portugal and Greece. As a remedy, Regling and Watson called for the kind of coordinated banking supervision that would later emerge in the shape of the Single Supervisory Mechanism¹¹, 2014's breakthrough in the euro area's move to banking union.

Although problems such as weak banks, high government debt, and inefficient labour markets were visible in 2008, the former ECB President Jean-Claude Trichet said that they were not yet appreciated: 'It was absolutely clear that many countries had no understanding of the loss of competitiveness incurred by a large number of countries during the first decade of Economic and Monetary Union,' he said.

While the euro area grappled with how to help members in trouble, a financial storm was hitting countries in central and eastern Europe. Banks with large exposures to this region came under significant market pressure, and, to prevent them fleeing these economies en masse, the 'Vienna Initiative'¹² was assembled in 2009 by a consortium of the Commission, the European Bank for Reconstruction and Development, the IMF, and the World Bank. These institutions worked together to coordinate crisis management proposals and to encourage parent banks to recapitalise their subsidiaries in eastern Europe, as well as to facilitate talks between debtors and creditors on how to navigate cross-border banking difficulties.

Latvia provided a foreshadowing of the troubles to come. In December 2008, it secured a €1.68 billion aid package from the IMF to help it through its economic and financial crisis¹³. However, to avoid disrupting its path to monetary union, Latvia chose to maintain the fixed exchange rate of the lats to the euro. The

¹¹ ECB (n.d.), 'Single Supervisory Mechanism'.

<https://www.bankingsupervision.europa.eu/about/thessm/html/index.en.html>

¹² European Bank Coordination (n.d.), 'Vienna Initiative', <http://vienna-initiative.com>

¹³ IMF (2008), 'IMF executive board approves €1.68 billion (US\$2.35 billion) stand-by arrangement for Latvia', Press release, 23 December 2008.

<https://www.imf.org/en/News/Articles/2015/09/14/01/49/pr08345>

resulting downward pressures on wages and pensions were followed by protests and, in early 2009, the collapse of the government¹⁴.

From there, the turmoil continued to spread. To Gaspar, who was monitoring developments from his analytical post at the Commission, the euro crisis seemed fundamentally different from previous regional flare-ups in Europe and elsewhere because of its focus on sovereign market access instead of currency fluctuations. 'I didn't see the development in financial markets and the sovereign debt crisis as analogous to an exchange rate crisis,' he said. 'I saw it instead as a crisis that affected the credit standing of sovereigns, in particular sovereigns that were perceived as fragile. So the issue was not only that of sustainability, but also the standing of sovereigns in the market.'

Credit-rating agencies, which should have been monitoring bank lending practices and sovereign debt risks, failed to do so. 'In the run-up to the financial crisis, we now know, they were over-optimistic with their ratings, but once the crisis hit, their ratings went into a very fast downward spiral',¹⁵ the European Parliament said in a 2016 report on how the credit assessment firms performed before and during the crisis.

As the crisis built, markets targeted more countries, said Schäuble, former German finance minister. 'At first, the pressure from the markets was limited to Greece. But it soon became clear that there was a risk of contagion.'

Maria Luís Albuquerque was watching the bond markets from her post at the time in the Portuguese debt management office. Albuquerque, who later became the country's finance minister, said: 'Leading up to the crisis, we saw that spreads on sovereigns were really crushed to a minimum, which was not consistent with the fundamental differences between different economies.' Portuguese 10-year government bond yields were close to Germany's, and in early 2005 even dipped marginally below, because investors were

¹⁴ Reuters (2009), 'Latvia government falls, president seeks new PM', 20 February 2009. <https://www.reuters.com/article/us-latvia-government/latvian-government-falls-president-seeks-new-pm-idUSTRE51J4G920090220>

¹⁵ European Parliamentary Research Service (2016), 'The case for a European public credit rating agency', Brussels, October 2016. [http://www.europarl.europa.eu/RegData/etudes/BRIE/2016/589865/EPRS_BRI\(2016\)589865_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/BRIE/2016/589865/EPRS_BRI(2016)589865_EN.pdf)

lumping together the risk of euro area countries. Later on, the trend would go the other way and spreads would widen to dangerous levels.

As the crisis heated up, investors pulled back, eventually preferring just one euro area country over the others. An initial 'flight to security' drove investors into a range of safer assets, namely sovereign debt, which later evolved into 'a flight to Germany', Albuquerque said. 'They were basically the only ones that could really attract money because investors were so craving safety.'

At the same time, the risk to global markets was mounting. Geithner, former US Treasury secretary, said: 'The world was very fragile at that point. I was deeply concerned with the risk that this would get out of control and the contagion would spread – it would have adverse implications for us, not just in Europe.'

The Commission began to lay the groundwork for a collective solution, without knowing where it would lead. In December 2009, planning began on a potential rescue package for Greece, whose fiscal deficit kept getting revised upwards – 'it exploded three times in three months,' said Olli Rehn, former European commissioner for economic and monetary affairs and the euro. These aid preparations continued through the Christmas break and into January. Instead of the planned 3.7% deficit for 2009, Eurostat put the fiscal deficit at 13.6% in its April 2010 report¹⁶, making one further final upward revision to 15.4% that November¹⁷.

In February, the new Commission took office, headed by José Manuel Barroso in his second term as president, with Rehn taking up his new economic commissioner post¹⁸. 'From that moment on, the Commission started to persuade Germany and France and then the other countries, especially the AAA ones, to agree on a stability fund. We didn't know exactly what form it should take, or could take,' Rehn said.

¹⁶ Eurostat (2010), 'Provision of deficit and debt data for 2009 – first notification', Press release, 22 April 2010. http://europa.eu/rapid/press-release_STAT-10-55_en.pdf

¹⁷ Eurostat (2010), 'Provision of deficit and debt data for 2009 – second notification', Press release, 15 November 2010. <https://ec.europa.eu/eurostat/documents/2995521/5051930/2-15112010-AP-EN.PDF/6704b50f-d771-4c98-889e-261a5f74396d>

¹⁸ European Parliament (2010), 'Parliament approves new European Commission', Press release, 9 February 2010. <http://www.europarl.europa.eu/sides/getDoc.do?language=en&type=IM-PRESS&reference=20100209IPR68680>

It was now evident that several countries were facing serious banking, macroeconomic, and/or market access issues – but how to deal with them was far from clear. Before Europe could move ahead to control the damage, it would need to agree on what kind of joint action made political sense. Some countries felt too strong a backstop would create ‘moral hazard’ and discourage countries from confronting their problems and taking necessary action. At the same time, others feared that asking private investors in sovereign debt to shoulder losses could destabilise the European bond market. Finding a balance between curbing contagion and encouraging reforms would be the euro area’s central challenge over the coming years.

'Runaway train': Greece sounds the alarm

3

*The Greek drama was a perfect storm.
It was foreshadowed by many other crises.*

Thomas Wieser

Chairman of the EU's Economic and Financial Committee
(February 2009–March 2011 and January 2012–January 2018) and of
the Eurogroup Working Group (October 2011–January 2018)

The euro's prospects darkened in October 2009, when a newly elected Greek government led by George Papandreou announced that the country's budget deficit was a lot higher than initially reported. When the incoming administration reviewed the figures, they saw that the country's budgetary gap, or the shortfall between revenues and spending, was projected to be around 12.5% of gross domestic product (GDP)¹⁹. That contrasted with the 3.7% of GDP projection submitted by the previous government and was four times the maximum threshold of 3% set out in the euro area's budget guidelines.

Given the exceptional circumstances surrounding the global financial turmoil, these budget targets had been relaxed, but they still offered a gauge of how far off the mark Greece had fallen. The huge fiscal deficit raised questions about the sustainability of

¹⁹ European Commission (2010), 'Report on Greek government deficit and debt statistics', COM(2010), 8 January 2010, p. 3. http://ec.europa.eu/eurostat/documents/4187653/6404656/COM_2010_report_greek/c8523cfa-d3c1-4954-8ea1-64bb11e59b3a

2001

1 January

Greece adopts the euro.

2001
2009

Government spending and borrowing increase but tax revenues weaken. Period sees rising wages, low productivity, and structural problems.

2009

14 January

Standard & Poor's downgrade: Greece to A- from A, the first in a series of downgrades leading to its eventual loss of investment grade.

21 October

Greece announces that the government deficit is much worse than previously reported. The 2008 deficit was 7.7%, not 5%, and in 2009 the deficit was planned to be 12.5%, not 3.7%.

2010

2 February

Greece announces measures to cut the fiscal deficit, including wage freezes.

11 February

EU leaders declare that they 'will take determined and coordinated action, if needed, to safeguard financial stability in the euro area'.

5 March

Parliament passes a package of measures that freeze pensions, cut civil servant salaries, and raise taxes.

15 April

Talks requested with EU governments and the IMF on a financial programme, and assistance officially requested on 23 April.

22 April

Eurostat revises the Greek 2009 deficit up to 13.6%, with a final upward revision to 15.4% on 15 November.

2 May

Eurogroup approves a three-year, €80 billion bilateral loan programme as part of a €110 billion international aid package, including the €30 billion that the IMF committed to on 9 May.

6 May

Parliament passes economic and financial legislation.

18 May

The euro area disbursed the first instalment of €14.5 billion, following a €5.5 billion disbursement from the IMF.

Greece's high and growing public debt – already in excess of a year's GDP. Fragile markets didn't receive the news well. Greek 10-year bond yield spreads to Germany widened to 238 basis points by the end of December from 138 basis points in early October, putting Greek borrowing costs at 5.49%, or 2.38 percentage points higher than Germany's and suggesting growing market concern about the country's finances.

'From that moment on it was clear there was a big problem,' said Maarten Verwey, at the time a senior Dutch finance ministry official, who would move to the European Commission in September 2011. 'There were a few months during which we could see that something coordinated needed to happen for Greece. But this was very difficult politically.'

In Greece, the revised figures also came as a shock. George Papaconstantinou, the new government's finance minister, remembers getting updated figures from his country's central bank just days after taking office. 'Before the election we had some idea that the numbers were wrong. But we just had no idea how wrong they were,' he said. 'That was the critical moment when we realised that it was a runaway train.'

Two days after the budget revisions came out, Fitch downgraded Greece's rating for long-term debt to A- from A. Greece's new figures showed 'weaknesses in fiscal reporting and planning' that cast doubt on the country's economic path, the credit-rating agency wrote in a 22 October 2009 press release. 'These ongoing deficiencies materially undermine the credibility of medium-term fiscal consolidation plans'²⁰.

On 8 December, Fitch downgraded Greece again, this time to BBB+ with a negative outlook – pushing the ratings down to two notches below where they had started the crisis. Standard & Poor's²¹ and Moody's²² followed suit later in the month. Investors had lost confidence in the Greek government's ability to right its finances in the foreseeable future. As Fitch wrote: 'Present government proposals rely more heavily on revenue-raising measures, particularly moves to counter tax evasion – where the pay-off is highly uncertain –

²⁰ FitchRatings (2009), 'Fitch downgrades Greece to "A-" from "A"; Outlook negative', Press release, 22 October 2009. <https://www.fitchratings.com/site/pr/521696>

²¹ TradingEconomics (n.d.), 'Greece – credit rating'. <https://tradingeconomics.com/greece/rating>

²² Moody's (2009), 'Moody's downgrades Greece to "A2" from "A1"', 22 December 2009. https://www.moody.com/research/Moodys-downgrades-Greece-to-A2-from-A1--PR_192460

rather than current spending where structural fiscal weaknesses are most acute²³.

The euro fell about 6% against the dollar in December, and declined against the currencies of the EU's major trading partners. EU leaders grew impatient with the government in Athens, and the rest of the world waited to see if Greece's problems would spread. Geithner, who helped spearhead the US response to its worst financial crisis since the Great Depression, was one of the earliest voices calling on Europe to avert a Greek default in order to protect the euro as a whole.

In early February 2010, Greece attempted to tame its deficit with measures such as wage freezes²⁴. Meanwhile, Geithner, then-German Finance Minister Schäuble, and the finance ministers of the other Group of Seven largest advanced economies met in Iqaluit, Canada, near the Arctic Circle. Geithner said he was beginning to fear that European reluctance to intervene would break the euro apart²⁵. International financial markets were panicking: if one euro area member state's statistics couldn't be trusted then all euro members were vulnerable. The EU political consensus was that Greece was to blame for its own problems. Geithner feared that relying only on budget cuts and what he called 'Old Testament'-style retribution could push the Greek economy over the brink. If the euro area would allow one of its own to default, financial markets might pull out of the currency bloc en masse, selling euro area government bonds or demanding punishingly high interest rates to hold on to them.

To many in the US, the EU seemed to be limiting its options. 'The initial proposals for creating a collective funding mechanism were small, relative to the scale of the challenge,' Geithner said. The risk of a just-big-enough safety net is that, if the market doesn't like your plan, investors will continue selling Greek debt, he said. Then 'you've accelerated the run, fuelling the fire because it looked so small' relative to the potential size of the problem. 'This is all about breaking the psychology of the run.'

²³ FitchRatings (2009), 'Fitch downgrades Greece to "BBB+"; Outlook negative', 8 December 2009. <https://www.fitchratings.com/site/pr/544018>

²⁴ European Commission (2010), 'Commission assesses stability programme of Greece; makes recommendations to correct the excessive budget deficit, improve competitiveness through structural reforms and provide reliable statistics', Press release, 3 February 2010. http://europa.eu/rapid/press-release_IP-10-116_en.htm

²⁵ Geithner, T.F. (2014), *Stress test: Reflections on the financial crisis*, Random House Business, New York.

Shortly after the Iqaluit talks, euro area leaders on 11 February 2010 held the first of a series of summits in Brussels to get to grips with Greece's financial woes and the consequences for the wider economy. They pledged 'determined and coordinated action, if needed, to safeguard financial stability in the euro area as a whole', but pointed out that Greece had yet to request support²⁶.

In that first top-level crisis discussion, the consensus was that it was up to Greece to put things right. Euro leaders leaned on the Greek government 'to do whatever is necessary' to tame the deficit and 'to implement all these measures in a rigorous and determined manner'²⁷.

An EU finance ministers meeting in mid-February set a deficit target for Greece of 8.7% of GDP²⁸ for 2010 and below 3% by 2012, in line with the stability and growth pact rules²⁹. The Greek government drew up a reform package designed to meet these goals, which the EU approved. On 5 March, the Greek parliament passed a package of measures that froze pensions, cut civil servant salaries, and raised taxes³⁰. The cuts caused nationwide protests, yet the EU insisted that more needed to be done. At their March meeting, the finance ministers welcomed Greece's actions, while calling for implementation of the full slate of promised economic reforms 'effectively, fully and in a timely manner'³¹.

At a summit a week later, on 25 March, EU leaders reiterated assurances that euro area member states were planning to act together if needed. While again stressing that Greece hadn't asked for assistance, the leaders pledged to offer a package of loans to Greece alongside an IMF programme, should it be required: 'As part of a package involving

²⁶ Statement by the Heads of State or Government of the European Union, 11 February 2010. <http://www.consilium.europa.eu/media/20485/112856.pdf>

²⁷ Ibid.

²⁸ Greece, Ministry of Finance (2010), 'Update of the Hellenic stability and growth programme, including an updated reform programme', Athens, 15 January 2010. http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/20_scps/2009-10/01_programme/el_2010-01-15_sp_en.pdf

²⁹ European Commission (2010), 'Memo on the Eurogroup and ECOFIN ministers meetings of 15 and 16 February 2010'. http://ec.europa.eu/economy_finance/articles/eu_economic_situation/2010-02-16-eurogroup_ecofin_en.htm

³⁰ European Commission (2010), 'Communication from the Commission to the Council: Follow-up to the Council Decision of 16 February 2010, giving notice to Greece to take measures for the deficit reduction judged necessary in order to remedy the situation of excessive debt', COM (2010), 9 March 2010. <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52010DC0091>

³¹ Economic and Financial Affairs (2010), 'Main results of the Council', Press release, 16 March 2010. https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/113398.pdf

substantial International Monetary Fund financing and a majority of European financing, euro area member states are ready to contribute to coordinated bilateral loans³².

European financial support wasn't a given. Papaconstantinou said Schäuble was blunt when the two first met in Berlin in late 2009. 'He used this phrase: "There is no Plan B, George. You have to handle it yourself."' France's Finance Minister Lagarde was similarly firm at the time, while acknowledging that there might be a need to reconsider as events unfolded, he said. Subsequent trips by Papandreou to Berlin and Paris yielded similar answers.

Papaconstantinou said he and Papandreou approached Dominique Strauss-Kahn, then IMF chief, during the World Economic Forum in Davos, Switzerland, in January 2010. Meeting in a kitchen so as not to attract undue attention, the trio had a frank talk about how much money might be needed and how the Washington-based lender could coordinate with EU authorities. According to Papaconstantinou, Strauss-Kahn said the IMF would help persuade the rest of Europe to find a way of helping Greece.

In March 2010, Verwey was appointed chairman of a group of national finance ministry experts tasked with looking into the complexities of the issues before the leaders' March summit. 'I did a first presentation about how the loan facility could be set up when I was chairman of the Task Force on Coordinated Action. This was a few weeks, about three, after we'd received the mandate from the leaders.'

Verwey's project was setting up what would become the Greek Loan Facility, a bundle of bilateral loans that would be pooled at the EU level and managed by the Commission. Some of the brainstorming from March and April 2010 would lead to many of the design features that ended up in the EFSF and the ESM, Verwey recalls. At the same time, there were some key differences. As a one-off arrangement encompassing 15 separate bilateral loans, the Greek Loan Facility was cumbersome and inflexible. Lending terms were also purposely less favourable than those the rescue funds introduced later.

³² Statement by the Heads of State and Government of the euro area, 25 March 2010. <http://www.consilium.europa.eu/media/21429/20100325-statement-of-the-heads-of-state-or-government-of-the-euro-area-en.pdf>

Euro area leaders phrased it as tough-minded encouragement for Greece to get its financial act together, going out of their way to say it wouldn't be cheap money. The 25 March statement said: 'The objective of this mechanism will not be to provide financing at average euro area interest rates, but to set incentives to return to market financing as soon as possible by risk adequate pricing. Interest rates will be non-concessional, i.e. not contain any subsidy element'³³.

The leaders said the loan offer 'has to be considered ultima ratio, meaning [...] market financing is insufficient.' Greece would have to be on the brink of default, with no other option but this last-resort, condition-laden lifeboat. Economic reform conditions would have to be negotiated, monitored, and agreed on before any disbursements would be possible. The March statement made it clear that the whole euro area – at that point, 16 countries – would be expected to participate.

Greece continued not asking for assistance – but the need was becoming palpable. At an 11 April meeting, euro area finance ministers hashed out a plan, while underlining that the rescue would include no subsidies. The starting point for pricing on the proposed bilateral loans would be the IMF's formula, with adjustments from there. The terms applied rates based on the three-month Euribor rate, plus a charge of 300 basis points, with a further 100 basis points for amounts outstanding for more than three years. A further charge of 50 basis points would cover operational costs³⁴.

These charges eventually proved counterproductive. With a worsening situation, there was no way Greece could stabilise its finances, mend its economy, and quickly repay loans with interest rates a full three percentage points or more above the 'normal' market rate for stable countries. These rates would be cut several times as Greece sank into recession and fell further behind on its commitments. For its EFSF-funded second rescue and ESM-funded third rescue, the euro area would help Greece with financing at cost. But, in the beginning, the goal was to make sure any lifeline came with expensive financing terms.

³³ Ibid.

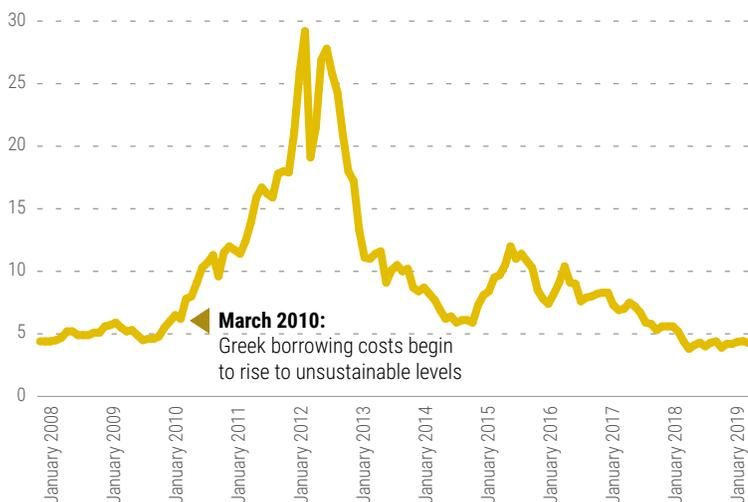
³⁴ Statement on the support to Greece by euro area Members [sic] States, 11 April 2010. https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/113686.pdf

10-year government bond yield – Greece

in %, monthly average

Revelations of Greece's fiscal woes led markets to push up Greek interest rates, with a debilitating effect on the economy. It took years for confidence to be fully restored. ESM crisis experience shows that rates beyond 6% suggest significant sovereign stress and imminent loss of market access³⁵.

Source: European Central Bank



On 15 April, the Greek government asked the Commission, the ECB, and the IMF to start talks about a multi-year assistance programme. The IMF's Strauss-Kahn agreed to send a team to Athens the following week, to prepare 'in the case that the authorities decide to ask for such assistance'³⁶. On 22 April 2010, Eurostat reported a Greek 2009 deficit of 13.6%³⁷, and bond yields soared to an average 7.8% in April from already unsustainable borrowing levels in March. A day later, the Greek government finally applied for help³⁸. The estimates for Greece's 2009 deficit would later top 15%, with Eurostat in November 2010 putting it at 15.4% of GDP³⁹.

³⁵ ESM (2018), *ESM annual report 2017*, p. 41, 21 June 2018, Publications Office of the European Union (Publications Office), Luxembourg.

<https://www.esm.europa.eu/publications/esm-annual-report-2017>

³⁶ IMF (2010), 'IMF statement on Greece', Press release, No. 10/152, 15 April 2010.

<https://www.imf.org/en/News/Articles/2015/09/14/01/49/pr10152>

³⁷ Eurostat (2010), 'Provision of deficit and debt data for 2009 – first notification', Press release, 22 April 2010. <https://ec.europa.eu/eurostat/documents/2995521/5046142/2-22042010-BP-EN.PDF/0ff48307-d545-4fd6-8281-a621cbda385d>

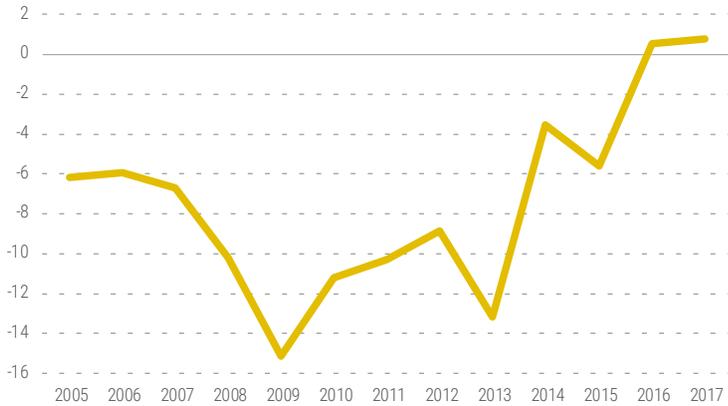
³⁸ European Commission, Directorate-General for Economic and Financial Affairs (2010), 'The Economic Adjustment Programme for Greece', *European Economy Occasional Papers* 61, May 2010.

http://ec.europa.eu/economy_finance/publications/occasional_paper/2010/pdf/ocp61_en.pdf

³⁹ Eurostat (2010), 'Provision of deficit and debt data for 2009 – second notification', Press release, 15 November 2010. <https://ec.europa.eu/eurostat/documents/2995521/5051930/2-15112010-AP-EN.PDF/6704b50f-d771-4c98-889e-261a5f74396d>

General government fiscal balance – Greece

in % of GDP



In 2009, the Greek deficit ballooned to 15.4%. Greece continued to struggle with deficits throughout the crisis, finally moving into surplus in 2016 during its third programme.

Source: Eurostat

The need to act together was becoming clear, even in countries critical of Greece. The fervour of German tabloids was widely reported⁴⁰, with their stark headlines, such as: ‘The Greeks want even more of our billions!’ There were many sympathetic voices, too. In a 3 May 2010 article headlined ‘We’re buying Greek government bonds!’, the editor of the German economic daily *Handelsblatt* asked readers to demonstrate trust in Greece by buying Greek government bonds and said that he himself had bought €5,000 worth⁴¹. The Dutch business daily *Financieele Dagblad* on 30 April 2010 said ‘The moment has come to support Greece’⁴². But, capturing the mood in Germany, the usually reserved *Die Zeit* cried, ‘Greece has violated all the rules of economic rationality’⁴³.

⁴⁰ *Guardian* (2010), ‘EU debt crisis: German papers whip up anti-Greece fury’, 29 April 2010. <https://www.theguardian.com/business/2010/apr/29/eu-debt-crisis-german-papers-whip-up-anti-greek-fury>

⁴¹ *Handelsblatt* (2010), ‘Wir kaufen griechische Staatsanleihen!’ (‘We’re buying Greek government bonds!’ (ESM translation)), 3 May 2010. <http://www.handelsblatt.com/politik/deutschland/handelsblatt-aktion-wir-kaufen-griechische-staatsanleihen/3426508.html>

⁴² *Financieele Dagblad* (2010), ‘Zware kritiek op Duitse regering’ (‘Serious criticism of German government’ (ESM translation)), 30 April 2010. https://fd.nl/frontpage/Print/krant/Pagina/Economie___Politiek/700583/zware-kritiek-op-duitse-regering

⁴³ *Die Zeit* (2010), ‘Genug, Athen!’ (‘Enough, Athens!’ (ESM translation)), 4 February 2010. <https://www.zeit.de/2010/06/Kommentar-Griechenland>

Prime Minister George Papandreou announces Greece's request for financial aid, in a seaside press briefing on the southeastern Mediterranean island of Kastelorizo on 23 April 2010.

Credit: Tatiana Bolari/AFP



After the Greek request, the aid talks moved quickly. On 2 May 2010, the Eurogroup agreed to provide bilateral loans managed collectively by the Commission in the Greek Loan Facility up to a total amount of €80 billion, to be released over the period May 2010 to June 2013⁴⁴. Germany committed the largest share of any euro area member state, pledging to offer up to €22 billion. But, unlike other member states, which funded the Greek loans directly, Germany delegated the credit line to its state-backed development bank, KfW⁴⁵. Alongside the euro area, the IMF put up an additional €30 billion under a stand-by arrangement.

Subsequent to the May 2010 deal, the headline amount in the Greek Loan Facility was reduced by €2.7 billion, in part because Slovakia decided later in 2010 not to participate, and in part because Ireland and Portugal stepped out once they requested financial assistance

⁴⁴ Statement by the Eurogroup, 2 May 2010. https://www.consilium.europa.eu/media/25673/20100502-eurogroup_statement_greece.pdf

⁴⁵ KfW (2010), 'Involvement of KfW Bankengruppe in financial support measures for Greece', 20 May 2010. <https://www.kfw.de/KfW-Konzern/Investor-Relations/Die-KfW-als-Emittentin/Publikationen/Newsletter-Kapitalmarkt/Update-2010/20.05.2010/index.html>

themselves⁴⁶. Overall, the difficult shared effort to make individual loans to Greece underlined the need for an alternative approach.

‘In principle, it would have been preferable to calculate the fiscal needs on the basis of a debt sustainability analysis. But, in practice, the spending limit of the Greek Loan Facility created a ceiling that could be used for the fiscal rescue of Greece,’ said Rehn, who was then the European commissioner for economic and monetary affairs and the euro. He credits Strauss-Kahn with making efforts to ensure the IMF’s contribution was as high as it was.

Even though the initial design was far from ideal, the euro area and its allies had come together to protect the currency union. ‘The idea behind the Greek Loan Facility was: we’ll do something for Greece now quickly,’ Verwey said. ‘Because people feared there would be contagion if we didn’t take action. They were especially afraid of contagion through the financial channel, through bank exposures to Greece – in countries other than Greece – so something needed to happen.’

The worries were justified. EU banks held around €95 billion in Greek government bonds, according to a May 2011 report by Moody’s⁴⁷, which noted ‘above-average’ exposures in Belgium, Germany, France, Cyprus, and Luxembourg. At the time, however, the prevailing wisdom in Germany and elsewhere was that Greek profligacy was to blame for the crisis.

To access the Greek Loan Facility funds, Greece agreed to a new wave of fiscal consolidation, on top of the cuts that were already underway, to prune its deficit to 2.6% by 2014⁴⁸. There were revenue-raising measures worth about 4% of GDP over the programme period, mostly by increasing the value added tax, for example on luxury items, tobacco, and alcohol⁴⁹. The programme aimed to modernise

⁴⁶ European Commission (n.d.), ‘Financial assistance to Greece’.
https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-financial-assistance/which-eu-countries-have-received-assistance/financial-assistance-greece_en

⁴⁷ Moody’s Investors Service (2011), ‘Weekly credit outlook’, p. 14, 16 May 2011.

https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC_133114

⁴⁸ European Commission, Directorate-General for Economic and Financial Affairs (2010), ‘The Economic Adjustment Programme for Greece’, *European Economy Occasional Papers* 61, p. 12, May 2010.

http://ec.europa.eu/economy_finance/publications/occasional_paper/2010/pdf/ocp61_en.pdf

⁴⁹ *Ibid.*, p. 14.

public administration, sell off state-owned enterprises, and slash defence spending while building a rational social safety net. It also set aside funds to shore up the banks and set up a structure to deal with financial stability.

Wage and pension cuts were at the heart of the efforts. The programme called for reductions in government entitlement and retirement programmes across society. ‘Selected social security benefits will be cut while maintaining benefits for the most vulnerable,’ the IMF said. ‘Comprehensive pension reform is proposed, including by curtailing provisions for early retirement’⁵⁰. The public sector was further targeted. Its administrative apparatus ‘was way less advanced than many would have thought,’ for example lacking a common registry for state employees so it was impossible to know how many there were, according to the euro area rescue fund’s Chief Economist Rolf Strauch.

The plan called on Greece to reduce and freeze pensions and wages for government workers, and it abolished the workers’ Christmas, Easter, and summer bonuses. The freezes would be in effect for three years, and the total effort included a wide range of measures. For example, it was designed to slash 5.25% of GDP in government spending through 2013, while raising 4% of GDP through various revenue measures. There were protections for the lowest-paid workers, and Greece was also supposed to strengthen its tax collection and budget controls to gradually recoup savings of 1.8% of GDP through structural reforms⁵¹. ‘A significant real devaluation – in other words a cut in real income – was unavoidable not only to reduce the fiscal deficit but also to improve competitiveness quickly,’ Regling said.

⁵⁰ IMF (2010), ‘IMF survey: Europe and IMF agree €110 billion financing plan with Greece’, 2 May 2010.

<https://www.imf.org/en/News/Articles/2015/09/28/04/53/socar050210a>

⁵¹ Ibid.

First Greek programme (2010–2012)

-  **Initial programme amount:** €110 billion
-  **Total amount disbursed:** €73 billion, of which the Greek Loan Facility disbursed €52.9 billion
-  **Lenders:** Greek Loan Facility (euro area, except Slovakia), IMF
-  **Final weighted average maturity:** not available, as not an EFSF or ESM programme
-  **Key legislated reforms:** pension system, health system, public financial management, state budget, public sector benefits, labour market, closed professions

The scope of the plan reflected the limits of what the euro area was able to offer Greece at the time, coupled with optimistic expectations about what Greece would be able to accomplish. This would eventually require the euro area to create its own aid fund, rather than stick with the loan facilities set up in Greece’s first rescue.

‘Perhaps we were too naïve about the Greek authorities’ willingness and ability to implement the structural reforms that were called for in that first programme,’ said John Lipsky, then the IMF’s first deputy managing director. ‘Long story short, very few of the agreed structural actions were implemented, and in total, the few that were undertaken were largely ineffective.’

The continued market volatility made it ‘obvious that some kind of funding mechanism was needed,’ Lipsky said. ‘It was only at the last minute, in the face of impending disaster, that agreement on the EFSF was reached.’

Its own budget efforts notwithstanding, Greece became increasingly unable to quieten market fears on its own, Papaconstantinou recalled. ‘The markets were not just looking for a fiscal consolidation attempt,’ he said. ‘The markets were looking for a backstop. They were looking for a guarantee of no default. And that was beyond us. This was not something we could do. This had to do with the collective response from the rest of the Union.’

In the week after the euro area signed off on the first Greek programme, the package made its way through national approval procedures and became ready to deploy. But there was no time to celebrate. ‘Eventually, the Greek Loan Facility was approved by the parliaments,’ Verwey said.

‘The last approval was received on 7 May, a Friday. But on that same day, the contagion was already there,’ he said. ‘By then it was clear we needed heavier ammunition.’

 Greek programme history continues in Chapters [19](#), [22](#), [36](#), [37](#), and [38](#).

The €750 billion weekend: the EFSF is born

4

It was a weekend of drama. The feeling that we were really walking on a tightrope, without a net below actually, the risk of imminent death was very palpable.

Marco Buti

European Commission Director-General for Economic and Financial Affairs (since December 2008)

By the time the Greek Loan Facility was agreed, contagion – the spread of financial instability across national borders – was on everyone’s mind. The European Council President Herman Van Rompuy, the former Belgian premier who led summits of EU leaders, expressed confidence that the new programme would allow Greece ‘to put right its economic and financial situation as well as its competitiveness’⁵². But he also laid out immediate plans for reinforcement of euro area governance, announcing a summit for 7 May ‘to conclude the whole process and to draw the first conclusions of this crisis for the governance of the euro area’.

Van Rompuy’s hope to ‘conclude the whole process’ was a bit optimistic. The events of that first May weekend would instead become one of the pivotal moments in a crisis that would propel five euro

⁵² Statement by President Van Rompuy following the Eurogroup agreement on Greece, PCE 80/10, 2 May 2010. http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/114128.pdf

area member states to seek help and force the ECB to unprecedented measures. Even before the leaders arrived in Brussels, it was clear that things were looking grim. ‘The Greek Loan Facility only calmed things for a few days in May,’ said Rehn, then the European commissioner for economic and monetary affairs and the euro. ‘Then all hell broke loose again on financial markets.’

European markets were imploding. There was almost no interbank lending, meaning the financial system’s usual ebb and flow had been replaced by huge traffic jams. The whole thing seemed on the brink of an acute crisis. ‘We had to cope with this intensification of the sovereign risk crisis in the euro area with Greece in a very dramatic situation – experiencing a sudden halt in financing. Global investors also considered that Ireland and Portugal were in situations of extreme danger and very close to a sudden stop,’ said Trichet, the ECB chief at the time.

Euro area leaders recognised that contagion threatened to undermine the common currency as a whole, but translating that insight into aid for individual countries was a fraught political enterprise. Verwey, a senior European Commission official who was with the Dutch finance ministry at the outbreak of the crisis, recalls the ‘mood music’ in the Netherlands. At the time, he said, a common attitude towards the Greeks was ‘let them sort out their own problems.’

It was a ‘very traumatic period,’ remembers Papaconstantinou, former Greek finance minister. When Greece finished negotiations for its first aid package, it had rekindled a brief feeling of hope. But then came ‘that awful week between the first bailout and the creation of the EFSE, where we all realised that we hadn’t solved the problem,’ he said.

One day before the summit, journalists had grilled Trichet over whether the euro area needed a procedure for sovereign defaults and whether the central bank would consider purchasing government bonds to prevent a financial collapse. ‘Default is out of the question. It is as simple as that,’⁵³ he said during the ECB’s 6 May press conference, sticking to the central bank line that forcing losses on euro area government bond investors would destroy credibility for the currency area as a whole.

⁵³ ECB (2010), ‘Introductory statement with Q&A’, Transcript, 6 May 2010. <https://www.ecb.europa.eu/press/pressconf/2010/html/is100506.en.html>

When he arrived in Brussels to meet with leaders, a pivotal moment approached. ‘It was Friday afternoon, very dramatic,’ Trichet recalled. ‘I did not hesitate to say that we had a dramatic situation in several countries in the euro area, as well as in the euro area itself. I had stressed the gravity of this situation every month since 2005 in the Eurogroup.’

Arguing that the euro area’s persistent divergences in labour costs, productivity, and competitiveness were a recipe for catastrophe, the central banker called on the leaders to set up new frameworks for the monitoring, governance, and bulwarking of the common currency. As Trichet made the case that Europe had an obligation to put its economic house in order, the leaders initially resisted. But Trichet pressed his point: ‘I was very, very strong.’

By the end of the evening, the euro area leaders had come around. As midnight closed in, the leaders agreed that Greece would receive the first cash infusion from its new rescue programme by 19 May. And they acknowledged that the problem went beyond Greece and would require a much broader approach. The 7 May statement called for stronger financial regulation and supervision, particularly regarding derivatives and ratings agencies. The leaders also pledged to ‘broaden and strengthen economic surveillance and policy coordination in the euro area’⁵⁴, by watching debt levels and structural measures that influence competitiveness, with stronger rules and tougher sanctions for those that didn’t keep up. Finally, they agreed to ‘create a robust framework for crisis management, respecting the principle of member states’ own budgetary responsibility.’

This new crisis-fighting framework would require a central anchor, of which the leaders had only a hazy idea at first. But they knew something had to happen by the Monday morning Asian market opening. They gave the Commission and the euro area finance ministers a very short timeline to come up with the details. ‘Taking into account the exceptional circumstances, the Commission will propose a European stabilisation mechanism to preserve financial stability in Europe,’ the leaders said in the statement, adding that euro area finance ministers would consider this proposal two days later, on Sunday 9 May.

⁵⁴ Statement by the Heads of State or Government of the euro area, PCE 86/10, 7 May 2010.
<http://www.consilium.europa.eu/media/27818/114296.pdf>

That put the Commission in the crosshairs. While Barroso, the Commission's president, was attending the leaders' summit in Brussels' blocky, brown Justus Lipsius building, on the other side of the Rue de la Loi, Rehn and his team were at work in the Berlaymont, the EU executive branch's glass and steel headquarters.

'The euro zone summit was on Friday and we had been preparing for it the entire week in the Berlaymont building,' Rehn recalled. 'We knew only very late that Friday night that we had a mandate from the euro area summit – not a very specific mandate – to come up with a proposal for a European stability fund by Sunday. So I had a brief sleep, took a quick shower, went back to Berlaymont early on Saturday morning and started to work with my team. We began looking at what policy initiatives could be economically viable and politically palatable in this dangerous situation.'

For the Commission's Benjamin Angel, then a head of unit in the economic and financial affairs directorate-general, there wasn't even time for a nap. 'On Friday evening, it was just before midnight and I was about to go to bed. Instead, my director-general called me and told me to go immediately to the Berlaymont. So I got dressed, went to the Berlaymont, and met until more or less 1.30 with my director-general, the secretary-general of the Commission, the director-general of the legal service, and the head of cabinet of the president's office. We needed to launch an initiative.'

Rehn was keenly aware of the political constraints that would shape any technical solution on offer. The summit statement was ambiguous on whether the crisis-fighting framework would be housed within the EU institutions or set up as an intergovernmental arrangement among euro area member states. The French president, Nicolas Sarkozy, and the German chancellor, Angela Merkel, had clearly reached some sort of understanding on what would be possible, but they hadn't shared publicly how far their governments were ready to go. 'We did not know what could have been agreed, or had been agreed, between Germany and France on the scale and size of the future fund,' Rehn said. 'We didn't know, and we couldn't find out.'

In the end, Rehn and his team didn't want to put the matter entirely in the hands of the member states from the outset, so they decided to look for a 'community method' solution that would make use of the EU budget framework. 'It was a very short proposal in the end, although it required a lot of work,' Rehn said. Angel worked into the morning for four hours, from 2.00 until 6.00, on the proposal for a Commission

emergency fund backed by the EU budget, which would become the European Financial Stabilisation Mechanism (EFSM)⁵⁵. He went to bed and on Saturday met briefly with Rehn and other colleagues. By Sunday, the Commission was braced to move ahead with the EFSM proposal while the finance ministers gathered for the bruising political battle to follow⁵⁶.

Angel remembers the Commission's top officials holding a longer-than-expected Sunday morning meeting before approving the draft, while the finance ministers were already waiting in the Justus Lipsius building for the negotiations to start on a text that no one had yet seen. 'It was really a unique situation,' he said.

The Sunday night finance ministers' meeting, chaired by Spain's Elena Salgado, turned into an all-nighter as Europe raced to put a firewall together before Monday morning trading began in Asia. As it turned out, the Commission's proposed EFSM vehicle, which Angel had drafted in the wee hours of Saturday morning, would not be enough on its own. A second marathon effort would be needed.

'I remember the night when the decision was reached to set up the EFSF,' recalled Wieser, former chairman of the Eurogroup Working Group. 'It was the night when German Finance Minister Wolfgang Schäuble fell ill when landing in Brussels on the aeroplane, so his deputy Jörg Asmussen had to step in until they could fly in the Interior Minister Thomas de Maizière. On the sidelines, again and again, I saw Christine Lagarde, then the French finance minister, standing by the window on the phone, and Asmussen on the phone as well, and there were interventions by the US president to both the French and the German leaders that night.'

As French finance minister, Lagarde was braced for the fight. She had been trying to enjoy a weekend break with her family at her country home in Normandy, but that was not to be. 'That Saturday pretty much all day long we had conversations with Wolfgang Schäuble, Olli Rehn, and Jean-Claude Trichet,' she said. 'It was supposed to have been a family weekend and there was no family time at all. And eventually, a decision was made. We all had to get together in Brussels on Sunday.'

⁵⁵ Council Regulation (EU) No 407/2010 of 11 May 2010 establishing a European financial stabilisation mechanism, OJ L118/1, 11 May 2010.

<http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1484663483987&uri=CELEX:32010R0407>

⁵⁶ Extraordinary Council meeting (2010), Press release, 9 and 10 May 2010.

https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/114324.pdf

So Lagarde threw on her suede jacket and took off for Brussels. The other players also began to gather. With Schäuble heading to hospital instead of the meeting, his deputy, Asmussen, was stalling for time until reinforcements could arrive: de Maizière, a close ally of Merkel. From Athens, Finance Minister Papaconstantinou also got the call. For once, Greece was not centre stage, having finished talks on its own programme a week earlier. The threat was clear, even if the solution was not. ‘Everybody realises you cannot have another Greek Loan Facility. So you cannot have coordinated bilateral loans. You need an instrument,’ Papaconstantinou said. ‘But nobody’s ready to create a fully fledged permanent ESM yet. We’re not there.’

Despite the sense of impending doom, the deal was not coming together. The Commission’s full plan for the EFSM ran aground when it went before the finance ministers on Sunday, on objections from Germany and other fiscally conservative states. As originally designed, it had two elements. Under the first rung of the plan, the EU would be able to borrow on financial markets, up to a limit determined by the bloc’s budget payment ceilings. That turned out to be about €60 billion and required the assent of all EU Member States, including countries outside the euro area.

Since €60 billion wasn’t going to build a firewall on the scale required, the Commission also proposed a second rung. When triggered, the Commission would still borrow on financial markets, but with direct guarantees from Member States instead of the EU budget. This was a tricky sell to the Council’s legal service, which almost immediately called for separating this second leg from the first and creating it outside the EU framework on the basis of an intergovernmental agreement.

‘Then the discussion became instantly extremely messy,’ Angel said. Germany and like-minded countries were backing a bilateral loan arrangement instead of the second EFSM tier, but other countries didn’t want a repeat of the Greek Loan Facility’s complexities. The Commission suggested an intergovernmental framework to provide guarantees to the Commission, but the Germans weren’t having it. ‘We were completely blocked,’ he said. The Germans, Angel recalls, saw difficulties with the Commission’s role, an erosion of trust in its ability to enforce strict rules.

Rehn said he met with Barroso and his economic advisor on Saturday afternoon and Sunday morning to discuss the options. ‘Based on our teamwork, I proposed we would present a combination of (a) using the EU budget as collateral to the own resources ceiling, which gave

€60 billion, and (b) beyond that, as needed and separately decided, asking the EU/euro area member states to provide joint and several guarantees to the EFSM.’ He added: ‘The latter part was regarded as a critical element to create a truly convincing “big bazooka”. Yes, it would have created eurobonds of some sort. Barroso first, and then after a lengthy debate, the commissioners endorsed the proposal on Sunday. However, the finance ministers did not endorse the latter part.’

With agreement on only the smaller component of the EFSM plan, talks were stalled. Rehn said he made a last-ditch proposal, offering to let the countries choose between guarantees and bilateral loans. But no luck. ‘Nothing seemed to fly that night, so we were fairly desperate and looking for some way out,’ Rehn said. ‘We had to have a convincing solution – or at least a convincing-looking solution – before those Asian markets opened.’

At this point, Lagarde told colleagues that they still had time, but not much. The Asian stock markets would be opening in quick succession soon and she warned that it was important to reach an agreement; they could not afford to throw in the towel. She predicted havoc in the markets if the EU was not able to come up with a convincing rescue package. She appealed for ministers to stay at least another 30 minutes: ‘I was constantly watching the opening of the Sydney stock market, then the Tokyo stock market. I mean, the clock was ticking.’

Verwey, who was mentally running through possible options for a firewall, in his capacity as chairman of the Task Force on Coordinated Action, also remembers asking Asmussen what the key concern was. ‘The problem was not the guarantee instrument,’ Verwey recalled. ‘The point was that Germany didn’t want to guarantee the Commission, because for them this was a big shift in the institutional balance between the Commission and the Council. The real question was: who controls the mechanism?’

As the clock ran out, Rehn called Verwey to a meeting. Midnight had already passed, but there was still no solution for setting up a new crisis mechanism. Besides Rehn and Verwey, only a few Commission staff were in the room. ‘We brainstormed. Why was it stuck and how could we solve that? Then I came up with the idea: why don’t we set up a special purpose vehicle? They liked the idea,’ said Verwey.

Rehn said he asked Verwey to check with the German delegation, if this would be okay for them. Verwey went, returning quickly with an affirmative from de Maizière, which ended the deadlock.

The special purpose vehicle concept was well suited to assuage the concerns of the fiscally more conservative countries that had come up during the debate, as a special purpose vehicle is usually created to solve targeted, and temporary, problems. It offered the added benefit of being relatively easy to set up and get running. Not only would it be out of the Commission's hands, it had a three-year time limit. It also bore no resemblance to anything that would sell common euro area debt, which was taboo for many countries. Instead, liability would be shared on a proportional basis among the euro countries.

For the rest of the euro area, the appeal was that the bigger rescue mechanism came with a guarantee system. The key feature was that the member states would guarantee not the loans to the programme countries, just the bonds sold on the market to finance them. This was particularly important for those economies that were themselves having problems accessing capital in the markets; they didn't want to be too closely linked to countries in worse shape than they were. They wanted to support the new framework with less damage to their own budget and debt statistics, and they wanted a system that they might actually be able to use if the contagion came their way.

Although the Commission backed the idea, its representatives were reluctant to present it to the Germans, given the evening's dynamic. So Verwey went instead. 'I asked them: 'Would you be able to accept this?' They did, and this then became the EFSF'

The signing ceremony establishing the EFSF on 7 June 2010 in Luxembourg.

Credit: George Gobet/AFP



Looking back, Commission President Juncker called the decision ‘historic’, adding: ‘Thanks to the political courage and ingenuity of a few of the people present, we took bold steps to defend the stability of the euro.’

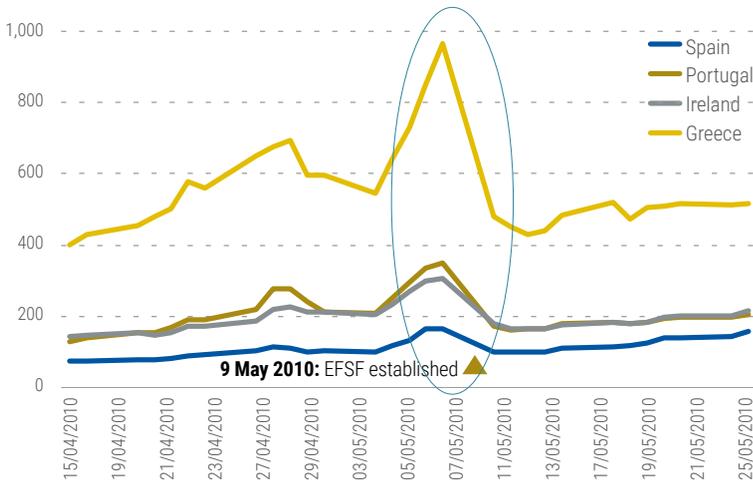
It was a momentous achievement for the euro area, and for its leaders. Lagarde, recalling the early morning press conference that followed, said: ‘We were all completely shattered, and probably looked terrible, but we were so proud to announce that we had finally put this thing to bed.’

For Schäuble, the creation of the EFSF, as a forerunner of the ESM, was proof that despite differences of opinion the euro area could act when it needed to and display solidarity, if there was the necessary conditionality. ‘That is very encouraging. All those involved were willing to work on reaching compromises that were necessary and in everyone’s interest.’

At this point, the official plan was still that the firewall would never be used. It would just be put in place, and put in place quickly, to calm the markets.

10-year sovereign bond yield spreads to Germany

in basis points, daily frequency



Bond yields of financially stressed countries moved higher despite the announcement of the first Greek programme. The creation of the EFSF on 9 May calmed the markets, briefly.

Source: Bloomberg

The next question for the new fund was: how big? Wieser felt the number had to be hefty enough to impress the markets or they would never calm down. 'I figured that €200 billion would be enough, but I also figured that certain member states would bargain me down by 50%, so I put in €400 billion. To my surprise, nobody bargained it down,' Wieser said. 'Then in order to make it a round figure, with the EFSM at €60 billion, we just tacked on another €40 billion to the EFSE, and that's how the €440 billion of the EFSF came into existence. It was not by design, it was a mixture of arithmetic and accident.'

At the end of that overnight marathon, the EU ministers announced that they had approved a total €500 billion euro area rescue fund. This would include a rapid-reaction EFSM of €60 billion and a special purpose vehicle that the euro area member states would guarantee. The vehicle would have a volume of up to €440 billion and would expire after three years, according to the finance ministers' statement of 9 and 10 May 2010⁵⁷.

With some diplomatic finesse, the euro area managed to convince the financial markets that it had an even bigger bazooka because the IMF would kick in another €250 billion. The IMF never put such a specific figure on it publicly, but its then-Managing Director Strauss-Kahn indicated as much after the meeting.

'The IMF will play its part, in the interests of the international community, in addressing the current challenges. In particular, we stand ready to support our European members' individual adjustment and recovery programmes through the design and monitoring of economic measures as well as through financial assistance, when requested,' Strauss-Kahn said. 'Our contribution will be on a country-by-country basis, through the whole range of instruments we already have at our disposal. We expect our financial assistance to be broadly in proportion to our recent European arrangements'⁵⁸. In that ballpark, the EU figured it could count on the IMF to pick up roughly a third of any new programme, with the other two thirds coming from the new firewall.

⁵⁷ Ibid.

⁵⁸ IMF (2010), 'Agreed EU support model boosts confidence, says IMF', 11 May 2010. <http://www.imf.org/external/pubs/ft/survey/so/2010/NEW051110A.htm/external/comments/index.aspx?type=rea>

In this way, the €750 billion first bulwark came into existence. The headline figure helped calm markets. To quell uneasiness at the EU level, the Commission still had a €50 billion balance-of-payments mechanism, available to help distressed non-euro countries, such as Latvia, Hungary, and Romania, with funds raised using the EU budget as collateral. Combined with the EFSM's €60 billion, a total of €110 billion in rescue financing was possible through Commission-administered funds – a point emphasised in communications with the European Parliament, which kept a close eye on euro area doings while representing the entire EU. The EU's entire budget for 2010 was an only slightly larger €122.9 billion, but the rescue mechanisms wouldn't touch that⁵⁹.

Central bankers and finance ministers around the world had been watching the EU's sleepless Sunday night. As the talks dragged on, there was a simultaneous conference call of finance ministers and central bankers from the Group of Seven major countries. And in Washington the IMF was on full alert.

'We were on the phone in Washington with the staff. This all was happening in the context of an endless conference call that went on for hours, and hours, and hours, between Brussels, the central bankers in Basel, plus participants in Washington, and who knows where else,' said the IMF's Lipsky, at the time Strauss-Kahn's number two. 'At least something concrete finally was agreed. The EFSF was announced only after markets had already opened in Asia. And, the ECB was ready to act in markets immediately, if needed.'

The euro area's cash could now be counted on. And although the permanent ESM didn't yet exist, its foundation had been laid. 'When the EFSF was founded on 9 May 2010, it was already clear to everyone that a European crisis mechanism could not, in the long term, be based on a guarantee-backed special purpose vehicle headquartered in Luxembourg,' Schäuble said. 'Nobody denied the need for a European crisis mechanism based on international law.'

⁵⁹ European Commission (2009), 'EU budget 2010: Investing to restore jobs and growth', Press release, 17 December 2009. http://europa.eu/rapid/press-release_IP-09-1958_en.htm?locale=en

Focus

The European Central Bank steps up

To give the new euro firewall time to get started, the ECB provided some much-needed breathing room. With the Securities Markets Programme, in operation through September 2012, the ECB aimed to preserve liquidity in euro area public and private sector markets through bond purchases⁶⁰. Under the programme, the ECB bought government bonds of Ireland, Greece, Spain, Italy, and Portugal. The scheme would improve the performance of malfunctioning segments of the euro area debt securities markets.

Shortly before the press conference announcing the new EFSF firewall, Rehn let the cat out of the bag that the ECB was moving simultaneously to reassure markets. Rehn had been told that the ECB would go public at midnight. So, thinking the ECB had already announced the move, he confirmed the action to the *Financial Times Deutschland*. 'I thought that, because it was 1.30 or 2.00 and I didn't want to look stupid, I said: "Yes, I'm aware the ECB has been acting." Because I was told they would go public at midnight,' Rehn said. 'So I revealed their Securities Markets Programme scheme, because I mistakenly thought they had already gone out, and also because I instinctively wanted to give the correct impression that the euro area now had a big bazooka to contain contagion in the financial markets. But they only did so later.'

The ECB's goal was to preserve financial stability by heading off breakdowns in trading and to strengthen the monetary policy transmission mechanism⁶¹. Some countries, however, were concerned that such operations could spark inflation by loosening the central bank's monetary policy stance. To prevent this, the impact of all operations was sterilised with technical measures that re-absorbed liquidity.

'I had enormous resistance from the governments on direct intervention in the secondary market, which was the only way to deter speculation,' said Trichet. 'We had the capacity to intervene immediately and the governments had to set up their own capacity.'

⁶⁰ ECB (2010), 'ECB decides on measures to address severe tensions in financial markets', Press release, 10 May 2010. <https://www.ecb.europa.eu/press/pr/date/2010/html/pr100510.en.html>

⁶¹ ECB (n.d.), 'Asset purchase programmes'. <https://www.ecb.europa.eu/mopo/implement/omt/html/index.en.html>

Enlisting Klaus Regling: 'I have his number'

5

[Klaus Regling] is an experienced policymaker who played an important role in the European integration process in recent decades and has a very good knowledge of how markets function.

Mario Draghi

ECB President (since November 2011)

When the euro area agreed to start a rescue fund, it needed someone to run it. In June 2010, during meetings in Luxembourg, finance ministers began kicking around the names of potential candidates. Several rose to the top, but Juncker, then chief of the Eurogroup, had a clear idea about whom to recruit.

'Klaus Regling is a leading expert in international and European finance. With him as CEO, the company's quality and credibility were secured from the start,' said Juncker, now European Commission president. 'It was only natural for me to insist on his nomination.'

Behind the scenes, the recruitment process was a little bumpier. Wieser, Eurogroup Working Group chairman during the crisis, was dispatched to run the search, alongside the finance ministers of Belgium and Malta. According to Wieser, when the time came for the three initial candidates to be interviewed, Juncker was furious that Regling wasn't on the list.

Klaus Regling, chief executive of the EFSF and managing director of the ESM, giving an interview in his Luxembourg office in 2018.

Credit: Steve Eastwood/ESM



‘He said, “Why haven’t you chosen one already?” Wieser recalled. ‘I said, “Well, first comes the closing of the call for candidates, then we arrange for interviews,” and he replied, “I’m not interested in that, I want everything to be done by tomorrow. And incidentally, I hope that Klaus Regling has been nominated by the German government.” I said, “No, Klaus is working together with Max Watson on some analysis for the Irish government, and he has not put forward an application”. Juncker was hopping mad, I’ve never seen him that way – “This is intolerable” – and then he turned to the Germans and asked, “Why the heck didn’t you propose Klaus?”’

It emerged that, on the day Wieser’s group of finance ministry deputies announced the search for chief executive candidates, the German representative hadn’t passed on the information to his home base. This oversight set off a scramble to track Regling down. ‘People were taking out their mobile phones and saying “I have his number somewhere,”’ recalled Heinrich, then a senior finance ministry official for Luxembourg.

Regling had just returned to Brussels after taking a fellowship at the Lee Kuan Yew School of Public Policy in Singapore to research financial and monetary integration in Asia. From his academic perch in the tropics – and the window of his high-rise apartment – Regling had tangible evidence of how the market turmoil was affecting the

world economy. ‘Every day, I saw the number of idle ships in the port increasing. World trade was coming to a standstill towards the final months of 2008. It was fascinating to see – and scary.’

As director-general for economic and financial affairs of the Commission from 2001 to 2008, Regling had become well known in every European finance ministry. In that position, he had attended all the monthly Eurogroup meetings of finance ministers, where he got to know Juncker, who started chairing the meetings in January 2005. There was an initial positive reaction from several ministers who knew Regling from this time and could vouch for his willingness to take a tough line with countries that were reluctant to follow through on their economic recommendations.

Regling had the level head and ‘sound technical understanding of what was happening’ to do the job, plus he was sufficiently accomplished in the policy arena with his Eurogroup experience, yet he wasn’t seen as a politician, Heinrich said. But he wasn’t sure Regling would want the job.

‘I had met him a few months earlier and he was all excited about his consultancy work,’ Heinrich recalled. Contacted at the last minute, Regling fortuitously happened to be in Belgium. Heinrich said that, when the EFSF call came, ‘to my surprise,’ Regling responded positively.

As a believer in the euro, Regling hoped that the proposed firewall fund would not be needed in the end, even if that meant any potential new job would be slow-paced. But he agreed to interview the next morning, and like the other candidates made his case in person. The choice was clear. ‘I reported back to a special and short Eurogroup meeting after that on the findings of the panel, which had decided on Klaus. It was incredible,’ Wieser said.

‘I never got a job so quickly,’ Regling said.

Lagarde, now IMF managing director who was French finance minister when Regling was chosen, credited ‘a fascinating combination of professional experience’ with making him perfect for the role. ‘He combines the layers of an internationally minded person, as a former IMF staff member, and a true and very deeply convinced European.’

Regling's good relations with all of his former employers, including the IMF, the German finance ministry, and the European Commission were an essential part of how the EFSF and ESM joined an already crowded group of negotiators.

The Commission's Angel said: 'For some of my colleagues it was not always easy to get used to the fact that there was another player in town whose needs and views we needed to take into account. That is over now. The fact that it was Klaus helped considerably because Klaus knew everyone. He managed to have the EFSF invited into the Eurogroup Working Group of deputy finance ministers and to the Eurogroup of finance ministers immediately. I'm not sure anyone else would have secured that so easily and so quickly.'

The goodwill lasted throughout Regling's first five-year term at the ESM, which followed his initial EFSF appointment, and has reached into a second, announced in February 2017. 'His appointment for a second term in office was very welcome,' said the ECB's President Draghi. 'His broad knowledge and experience have been very beneficial for the functioning of the ESM and cooperation with the ECB.'

Focus

A life in public service

Klaus Regling was born on 3 October 1950, in Lübeck, West Germany, right at the border with East Germany. He was the son of a master carpenter, who ran his own carpentry business and sat in the German parliament, the Bundestag, for the Social Democrats from 1953 to 1969. Politics and economic issues were the order of the day in the Regling household.

Regling studied economics in Germany, earning a bachelor’s degree from the University of Hamburg in 1971 followed by a master’s degree at the University of Regensburg in 1975. He began his professional career at the IMF in Washington DC – the start of a 40-year journey in public service that would take him around the world.

From 1980 to 1981, Regling worked for the Association of German Banks before taking up his first post at the German finance ministry, where he would remain until 1985. Then it was back to the IMF: first at the international capital markets unit in Washington, and then as the IMF representative for Indonesia in Jakarta, furnishing the start to what would become a rich experience dealing with crises.

During the 1990s, Regling rose through the ranks of Germany’s finance ministry, serving first as chief of the international monetary affairs division, and then becoming deputy director-general for international monetary and financial relations. He was a key contributor to the effort to build a European Economic and Monetary Union, experience that would stand him in good stead when the time came to build up the EFSF and ESM.

In 1995, the same year ‘euro’ was chosen as the name for the new currency, Regling became the German ministry’s director-general for European and international financial relations, taking an active role in negotiations within the EU and the Group of Seven industrialised democracies, and playing an important role in preparing for the euro’s 1 January 1999 debut.

His role meant he attended meetings of the Group of Seven countries at the height of the 1997 Asian financial crisis. This complemented his earlier IMF assignments, on which he had seen the aftermath of the mid-1980s Latin American debt crisis up close. At that time he had been involved in designing instruments – such as the Brady bonds, designed to help developing

countries turn bank debt into bonds with backing from the US Treasury – and, in turn, aid banks in coping with the losses from the episode. Because of that experience and his work as an IMF representative a few years earlier, the Indonesian government invited Regling to come to Jakarta several times in 1998 – the height of the Asian crisis – to help design a solution for the public debt crisis.

To understand Regling's thinking, it is worth looking at the Asian crisis, which he witnessed at first hand. The financial crisis offered some lessons for the EU. The three economies that were hit worst – Indonesia, South Korea, and Thailand – had continued to link their currencies to the dollar as the US currency depreciated. These export-focused east Asian economies thrived on the low dollar, but, when the currency began recovering in 1996, their competitiveness rapidly evaporated. The Asian crisis was triggered by that loss of competitiveness, aggravated by high public debt and, in some cases, by banking problems.

The crisis took off in July 1997 when Thailand allowed the baht to float because it was running out of foreign currency to defend its peg to the dollar against speculative attacks. The baht collapsed, sparking contagion across the region: Malaysia, the Philippines, and Indonesia were caught up in the turmoil and even Singapore's dollar began to decline. The upheaval led a spate of countries to seek support from the IMF, which in turn fostered public ire at what was perceived as harsh austerity imposed from the outside. It also prompted discussion of an Asian Monetary Fund.

An Asian Monetary Fund did not come to pass at the time. But a group of neighbouring countries did in fact turn to regional tools to address the unfolding crisis in East Asia. Before their crisis, members of the Association of Southeast Asian Nations and their 'Plus Three' partners – China (including Hong Kong), Japan, and South Korea – had already devised a series of bilateral swap arrangements as a way to address short-term dollar liquidity crunches, a small first step in creating a regional mechanism for managing a financial crisis. The Chiang Mai Initiative has since expanded into a multilateral currency swap arrangement among the participants, the so-called CMI Multilateralisation with a pool of \$240 billion in foreign reserves.

The EU didn't heed these lessons when it designed the euro, failing to pay sufficient attention to developments in competitiveness, and it had no internal buffers against capital market headwinds, Regling said. 'We didn't have rescue mechanisms. We needed some of these tools but they did not exist, even though the lessons might have been learned from Asia in 1997.'

As well as demonstrating how fast contagion can spread, Asia's travails had other lessons for the EU, namely the limitations of using floating exchange rates to tackle deeper structural imbalances. 'An exchange rate can be very useful sometimes but it can also be very risky on other occasions,' Regling remembers. 'Indonesia tried everything in 1997–1998 to stop the depreciation of their currency but they were not able to do so. In the end, the Indonesian rupiah depreciated by almost 90%, which meant that everybody with foreign currency debt – the sovereigns and companies – went bankrupt.'

Of course, euro area countries no longer had currencies of their own to devalue in nominal terms. Even so, real exchange rates move in a monetary union and should be monitored closely. 'Every crisis is different, but it is good to try to remember what happened in other crises,' Regling said.

In 1998, Germany elected a new government, leading Regling to take a break from the public sector. The incoming finance minister, Oskar Lafontaine, felt that the country's economic difficulties were mostly due to weak demand. Regling pushed back, saying the country needed structural reforms and not just more spending. 'After five minutes, he realised I was a hopeless case,' Regling recalled, noting that he left the ministry on friendly terms.

Seeking a new perspective on the financial world, Regling joined a London-based hedge fund, Moore Capital Strategy Group, serving as managing director from 1999 to 2001. 'It was a good experience, but after two years I was ready to move on,' he said.

Opportunely, Regling's 'dream job' opened up at the European Commission in Brussels. From 2001 to 2008, he served as director-general for economic and financial affairs, one of the institution's most important civil service posts. While there, he was instrumental in implementing the new framework of oversight and guidance that came in with the common currency, and he won the lasting respect of his colleagues.

Regling left the Commission not because he was tired of his job, but because the EU's strict institutional rules meant he could keep the same post for only seven years and he couldn't think of anything else he'd rather do there. He accepted a year-long academic fellowship in Singapore, then returned to Europe in late 2009 to open an economic and financial consultancy in Brussels, where he was content until Europe came calling with the next opportunity.

Shortly after Regling left, the Commission produced a retrospective⁶² on 10 years of the euro, and its authors awarded him a signal honour. Gaspar, former finance minister of Portugal, who was one of the co-editors alongside Buti, Regling's successor as the Commission's director-general for economic and financial affairs, said: 'This book is dedicated to Klaus Regling. And that is not a coincidence.'

⁶² European Commission (2010), *The euro: The first decade*, eds: Buti, M., Deroose, S., Gaspar, V., and Nogueira Martins, J., Cambridge University Press, Cambridge.
<https://publications.europa.eu/en/publication-detail/-/publication/befd33a4-e826-4e6e-b5f5-f625fe849b7a>

All eyes on Luxembourg: 'let's do this'

6

*We all were willing to go all the way
in the beginning. We gave up weekends,
gave up holidays.*

Kalin Anev Janse
ESM/EFSF Secretary General

The EFSF had to move quickly: the euro area's new fund had only a three-year lifespan. First, it needed a home.

Luxembourg was the consensus choice. Tucked away between Belgium, France, and Germany, the Grand Duchy is known for its financial savvy and stalwart support for the European project. In addition to being the home country of Juncker, the current European Commission president who was then the premier of Luxembourg and head of the euro area finance ministers' group, the Grand Duchy was also recognised as a financial industry hub. Luxembourg is home to many banks, pension funds, and wealth managers, given its regulatory and legal framework and its status as the second-largest investment fund centre in the world. One of Europe's smallest countries, with a population now around 600,000, it was already home to such EU institutions as the EIB, the Court of Justice of the European Union, and the European Court of Auditors.

On 7 June, less than a month after the go-ahead for the new mechanism, the EFSF was legally established by the Eurogroup. When

the time came to put the paperwork in order, its birth a few weeks later was both prosaic and momentous. Its founding chief executive, Regling; its director, Heinrich, who was also Luxembourg's treasurer-general; and Luc Frieden, then Luxembourg's finance minister, assembled in a meeting room on the third floor of the finance ministry with a local notary, Maître Jacques Delvaux. There had been some talk of an even more ad hoc operation, but Delvaux found the occasion significant enough to hold an impromptu ceremony. 'He said "oh, for something like that, for a historical event like that, I'm going to come down myself to the ministry,"' Heinrich remembered. 'Then he was reading out the *acte notarié* to us and setting up the company.'

For the first few weeks, Luxembourg would be the EFSF's sole shareholder after it was incorporated as a company under Luxembourg law. Hosting the temporary firewall prompted little domestic controversy. 'In other countries, that could have led to drawn-out parliamentary discussions. Here in Luxembourg, we decided expeditiously: "Let's do this," and we did,' said Heinrich. To get the EFSF operational, Luxembourg furnished €31,000 as start-up capital and provided a loan for initial operating expenses.

The EFSF had a public service mandate from its inception, and it would grow into an international financial institution in the form of its permanent successor, the ESM.

The first EFSF meetings were an awakening for the finance ministry deputies who made up its board, many of whom were economists used to analysing data and solving thorny political problems – not running a company. In those initial weeks, Heinrich was the lone director of the EFSF until all the euro area states had joined. Later, from December 2011 to March 2014, he would serve as chairman of the EFSF's governing body, the Board of Directors.

This corporate structure had some interesting requirements. For example, Heinrich remembers having to read speaking notes prepared by the EFSF's legal advisors at the start of every meeting or conference call, and he said he became an overnight expert in Luxembourg's corporate law.

Then there was the question of personal liability. Italy, which has a history of public officials serving on private boards in their official capacity, determined that EFSF directors might have personal liability if the firewall ever defaulted on one of its bonds. So, just in case, the

Italians arranged to insure their representative for the princely sum of about €2 billion. Heinrich said that, paradoxically, the out-of-this-world figure took the pressure off other countries to provide similar insurance, and put him at ease about taking on personal responsibility for the fledgling fund. ‘If it were €1 million or €250,000, maybe I would be worried,’ Heinrich said. ‘But if it’s €2 billion, we’re done for anyway, so stop worrying about it. This €2 billion is an amount that is too big to rationalise,’ he said, adding: ‘We shelved that discussion.’

For legal corporate governance reasons, member states were not allowed to designate alternates but instead needed to issue proxies to each other’s representatives for meetings when their representative could not attend. Because of the urgency of the crisis, the EFSF board meetings contacted participants no matter where they were, or what the time of day.

‘Today, when I travel, I still remember all of the various places from which I’ve chaired EFSF Board of Directors conference calls: in the departure or arrivals halls of airports all over Europe, and the TGV to Luxembourg, on the beach in Borneo where there was a huge thunderstorm,’ Heinrich said. ‘We were having these conference calls, all of us, in the most unlikely places, just all over the world.’

Regling had been shepherding the new organisation from its inception, and on 1 July he officially stepped into the role of chief executive officer. On taking the helm, Regling had to deploy all of his considerable connections and management skills. Everything from trading software to the most mundane office materials needed to be bought and installed.

‘Building up the two institutions from scratch under considerable pressure is not easy work. But he did a terrific job,’ said Furusawa, deputy managing director at the IMF, who knew Regling from his early IMF days.

Regling drew on the EU’s existing expertise to set up the fund as quickly as possible. The Commission, the ECB, and the EIB all promised to lend aid and sent over one staff member each. ‘They all knew this would create a lot of work initially to set it up. They all promised to help,’ Regling said. ‘I had nothing – there was no office, no staff, no telephone number, no email address.’

The EIB was a first port of call in getting the new organisation off the ground. The EIB hadn't wanted to take on the rescue mission in addition to its existing portfolio, but it was willing to lend a hand in the build-up phase. Regling recalls his first meeting with his new neighbours, at which about 15 EIB staffers briefed him on what needed to be done. 'Each one explained to me what I needed to do in a different area – from recruiting staff to organising an office. And then on substance, it was rating agencies, preparing for issuing bonds and bills. It was amazing,' he recalled.

Focus

A role for the European Investment Bank?

Early in the euro area's crisis-fighting brainstorming, the EIB popped up as a potential vehicle for providing third-party, market-oriented aid. However, taking on an ambitious new mission would have required new capital for the EIB to ensure its hold on its essential AAA credit rating. A further complication was that the EIB is an EU institution that represents all EU Member States and operates around the world, whereas the EFSF would be designed to target the single currency area alone. The EIB's Members were not looking for the investment bank to take on greater exposure to the euro area.

In the end, Member States decided that crisis-fighting powers weren't a good fit with the EIB's traditional role of financing development projects in Europe and around the world. But the EIB could offer advice, staff, and office space.

'We had a lot of long crisis meetings with EIB risk, legal, finance, and corporate governance to decide how best to handle it. The uncertainty of the EFSF rating was a big issue for the EIB. There was a fear that the EIB's rating could deteriorate. At the same time, the EIB wanted to help, in the end deciding to do so at arm's length,' recalls Secretary General Kalin Anev Janse, who worked at the EIB at the time and was coordinating the EIB's support for setting up the EFSF.

As his second-in-command and chief finance officer (CFO), Regling hired Christophe Frankel, a Frenchman who had served in senior positions at the French government debt agency and in private sector finance. Strauch, who had been at the ECB, also joined immediately as chief economist.

Starting with a blank slate was intimidating but also offered opportunities. ‘It was a challenge but at the same time very positive,’ Frankel said. ‘We could build something that was really adapted to our needs.’

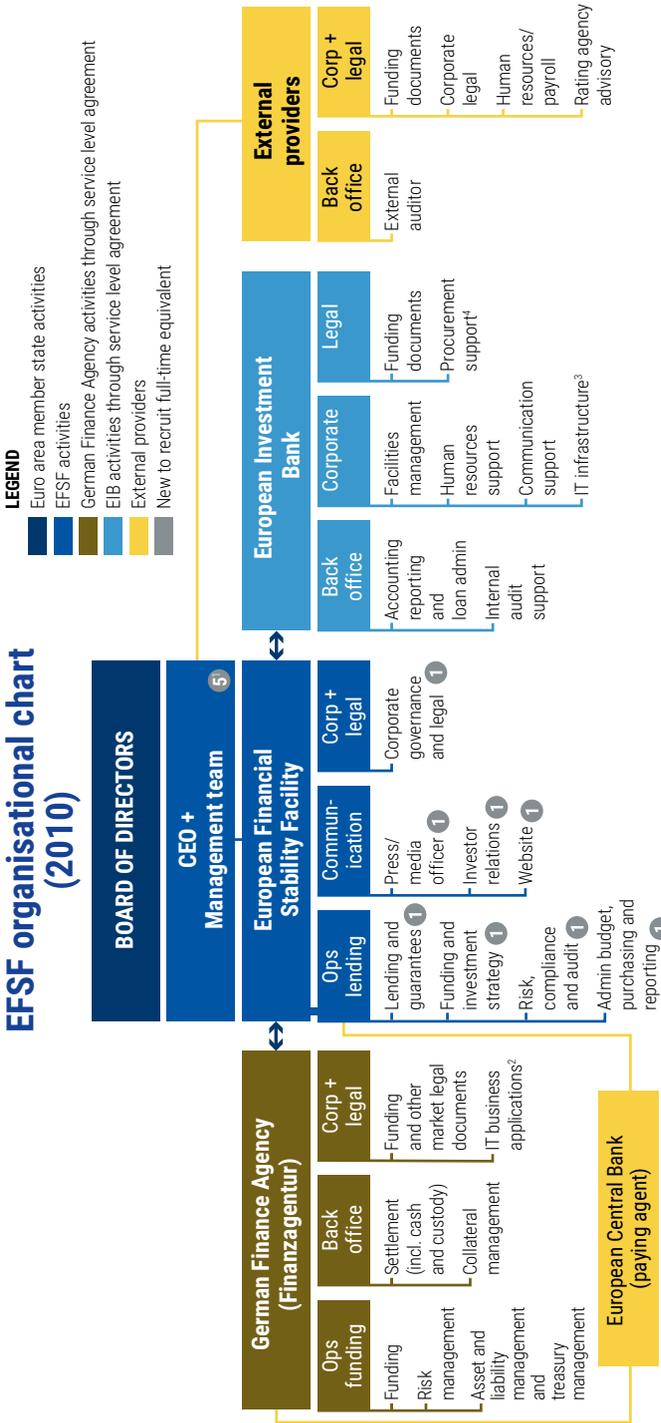
Regling outsourced whatever he could. For example, market borrowing operations would be carried out by the German Finance Agency and the EIB would handle accounting and information technology. He also turned to Anev Janse.

Only a few years out of university, where he had been active in Dutch politics, Anev Janse was working at McKinsey & Company and then moved to the EIB for a one-year secondment during the crisis. He was then assigned to the EFSF project, where he would begin building the EFSF’s internal structure while Regling, Frankel, and Strauch focused on winning over the policymakers and markets. As it happened, Anev Janse was wheeling his suitcase out the door for a trip to Amsterdam, but his supervisor stopped him: plans had changed. The call had come in to work on the EFSE, and that would be Anev Janse’s job. The temporary assignment became permanent when Anev Janse was appointed the firewall’s secretary general starting in 2011. He was impressed by Regling from the start.

‘As a boss he is great,’ Anev Janse said. ‘He trusts his staff. He can be tough and very challenging at the same time; he’s very clear about what he wants delivered.’

The EFSF was originally conceived of as a 12-person shop, as shown by the institution’s founding organisational chart. This staffing framework was one of the first data points Regling could show to a curious yet cautious global investor base as part of the long process of building confidence. In July 2010 – before the firewall was fully up and running – Regling took the chart to an Asian investors’ conference in Beijing hosted by Singapore’s sovereign wealth fund.

EFSF organisational chart (2010)



1) 1xCEO, 2xSecretary, 1xChef de Cabinet and 1xResearch
 2) IT business applications = specific IT business solutions (market data: dealing platforms, capital markets and treasury)
 3) IT infrastructure = basic IT solutions (PCs, internet, printers, smart phones, etc.)
 4) Administrative support, especially on reviewing the tender documents (obliged for procurements above €35,000 by Luxembourg law)

The first draft of the EFSF organisational chart, with key tasks outsourced to the ECB, the EIB, the German Finance Agency, and external service providers. Over time, the EFSF would bring more of these functions in-house. (This chart is edited to remove the names of external providers.)

Source: EFSF archives

The organisational chart was never an exact model. From the very beginning, new hires took on multiple roles and dedicated their waking hours to getting the firewall off to a good start, and functions were expanded or absorbed as the organisation grew. Conceptually, however, the organisational chart was instrumental. The first step for the new firewall was literally centring itself in order to get organised.

‘When Kalin did the first organigram with me, he wanted to put the EIB in the centre and the EFSF was on one side. I said “No, no. We should change this around. The EFSF is at the centre and the EIB is on the side, alongside the German Finance Agency,”’ Regling said.

A dozen people was a lean concept for an organisation as ambitious as the EFSF, and even that number did not assemble overnight. ‘The concept of having 12 was not stupid; it was possible to do this,’ Regling said. One can do a lot with just a few people, who work very hard. And we had the support of the German Finance Agency and the EIB.’

The early team was extraordinarily dedicated – as they needed to be. The crisis was turning so many lives upside down, and everyone who signed up was motivated to do as much as they could. It certainly



The EFSF’s first office had a makeshift feel, in keeping with the rescue fund’s hasty set-up and a determination to hold down costs.

Credit: EFSF archives

couldn't be only for the money. 'We never spent in an exaggerated fashion,' said Ralf Jansen, the firewall's first general counsel. 'There was always this sense of soberness. Being down to earth. Not overdoing it. How would you talk to a Greek pensioner absorbing a cut if Klaus lived a life of luxury?'

Jansen welcomed the prospect of joining a team with a purpose larger than itself. It was a unique opportunity to do something that people might one day consider historic. There was no roadmap, no time to worry about what would happen if something went wrong. 'We joined for the project. It's amazing looking back – the amount of money and risk we dealt with. Coordination basically took place while we were doing it.'

As the EFSF started operations and the euro area began expanding the facility's duties while planning for a permanent fund, it became clear that the firewall would have to be beefed up. Shareholders would expect the rescue fund to have ironclad risk management and auditing abilities, given the amount of money at stake.

Recruiting letters went out to other international financial and private sector institutions. 'It was a call for help – we are trying to manage this crisis, we need help and we need your people,' Anev Janse said. 'The way we came together was a bit of coincidence, but that made us extremely strong.'

Early days: the EFSF and its doubters

7

The €750 billion comes about and you have the birth of the EFSF. And it worked. I mean, the next morning papers were jubilant. This was seen as a bazooka – finally the Eurogroup is ahead of the curve, finally no longer water pistols.

George Papaconstantinou

Greek Finance Minister (October 2009–June 2011)

Outside Europe, the establishment of the rescue fund was seen as a key turning point. In late June 2010, leaders from the Group of 20 major industrialised countries met in Toronto to take stock of the global economic outlook. The group, which comprises 20 of the biggest economies in the world, classified the creation of the EFSF, the European Financial Stabilisation Mechanism, as well as the stress testing of EU banks, as ‘substantial contributions to our collective well-being’⁶³.

But inside the EU the firewall had critics. For some countries, the very existence of a crisis-fighting mechanism created the risk that politicians might rely on it, instead of facing up to hard choices at home. It would take time for detractors to build trust in this new

⁶³ The G-20 Toronto Summit Declaration, 26 and 27 June 2010, Paris.
<https://www.oecd.org/g20/summits/toronto/g20-declaration.pdf>

instrument – even though no one saw an immediate alternative to the temporary firewall.

For countries in economic distress, the EFSF's chief downside was that the granting of financial aid was by unanimity, a requirement that could frustrate quick decision-making, or block any decision-making at all. For better-off countries that would underwrite rescue programmes, the fund was unthinkable without this veto power.

As the economically weightiest euro area member state, Germany was often seen at the forefront of an alliance of countries seeking to limit the use of the new firewall. From the outset, one of Regling's biggest tasks as EFSF chief executive would be to bridge the gap between public sentiment in the north and in the south, making sure the rescue fund was attuned to the needs of all of its stakeholders.

'Often it was not Germany alone; it was a group of five or six countries,' Regling said. 'Another 12 countries wanted to be more generous. That's our situation. We cannot say that one half of our members are right and the others are wrong.'

Scepticism had its roots in the EU Treaty, which prohibits the assumption of an afflicted country's debts by another country or by the EU⁶⁴. This no-bailout clause put each country in charge of its financial fate, and the stability and growth pact prevented countries from amassing destabilising debts – or so the theory went. It took time, and the experience of cross-border market turmoil, for European public opinion to warm to the notion of collective responsibility for monetary union.

'That is why it was so difficult,' said Verwey, a senior Commission official who had been one of the EFSF's main architects. 'That had been the story in the Netherlands and Germany for a long time: "We have the no-bailout clause and the stability and growth pact, so a crisis just won't happen."'

The EFSF's untried legal basis didn't help matters. Legal challenges to the rescue fund would be filed – and eventually defeated – in Germany, Estonia, and Ireland.

⁶⁴ Treaty of Lisbon amending the Treaty on European Union and the Treaty establishing the European Community, OJ C306/1, Article 125, 17 December 2007.
<https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A12007L%2FTXT>

Owing to the political sensitivities, the EFSF came into being with an unspoken understanding that it wouldn't be called upon, at least in the short term. Strauch, its chief economist, said the new institution was part of an EU-wide learning process. 'From a Dutch, Finnish, or German point of view, it needed to be crystal clear at that point in time that rescue loans could only be used as a very last resort,' Strauch said. 'Giving easier access would have been impossible to sell politically and subject to legal challenge in parts of northern Europe.'

These built-in restrictions posed a dilemma for crisis management. Without them, there would be no EFSF; but with them, there was a risk that aid would be delayed or denied. Buti, the Commission's director-general for economic and financial affairs, said this hamstrung the euro area's ability to get ahead of the contagion. Financial rescues, he said, would be mounted only as an 'ultima ratio' 'to collectively make unprecedented decisions and cross no-go lines only in those types of conditions where you are backed against the wall and there is no way to go back.'

It was a costly trade-off, as the next set of rescue programmes would show. 'It meant procrastinating until you were staring into the abyss,' Buti said.

To move forward, the EFSF would need approval from all euro area governments. Some countries saw an immediate benefit in preparing a common defence against future market disruption. Although Malta wasn't directly in the line of fire, it felt a sense of urgency about the looming crisis, said Camilleri, permanent secretary for budget and finance in the Maltese finance ministry.

'We are a very small, open economy. Whatever happens elsewhere is bound to hit us,' Camilleri said. 'It was not perceived as somebody else's problem. If there is a problem, it's also our problem.'

As the crisis rippled through Europe, political alignments started to shift in the more financially solid countries. Anti-bailout movements emerged in Germany, in Finland, and elsewhere. The electoral consequences were first felt in Slovakia, which having joined in 2009 was then the euro area's newest member – and its poorest, with real per capita GDP of €11,900, compared with €21,500 for Greece⁶⁵.

⁶⁵ Eurostat (2019), 'GDP and main aggregates – selected international annual data.'
http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=naida_10_gdp&lang=en

Slovakia had done its homework to adopt the euro, imposing discipline on its public accounts and posting a debt-to-GDP ratio of 36.3% in 2009⁶⁶, well below the euro area average of 78.5%. These fiscal exertions coloured Slovaks' attitudes towards contributing to what they saw as the high cost of rescuing a wealthier country whose own irresponsible fiscal behaviour had led to its crisis.

Slovak voters picked a centre-right governing coalition in June 2010 elections. Iveta Radičová, a critic of financial assistance for Greece, became prime minister. Radičová's government sought to balance EU and domestic pressures by positioning itself as a champion of reform, pushing for a tough stance against countries that break the debt and deficit rules underpinning the euro.

Under the EFSF's original design, Slovakia's share of the guarantees for the temporary firewall was around €4.4 billion, on top of the €816 million it had been asked to make available to Greece as part of the Greek Loan Facility⁶⁷. In Bratislava, the twin commitments weren't politically reconcilable. Slovakia decided that its precondition for approving the EFSF was to pull out of the bilateral loan framework.

On 15 July, Radičová's government ratified the creation of the EFSF as one of the last countries to do so, while declining to take part in the bilateral Greek programme. The price it exacted for endorsing the rescue fund foreshadowed bigger fights as the crisis deepened and the euro area was forced to increase its response capacity.

For Rehn, then the European commissioner for economic and monetary affairs and the euro, Slovakia's refusal to extend loans to Greece constituted 'a breach of solidarity,' he stated at the time⁶⁸. The move wouldn't hamper disbursements of Greece's loan package, but he said it undermined 'a crucial act at a critical moment to safeguard financial stability of the euro area as a whole, including Slovakia.'

Even as they managed to create innovative solutions to the crisis, the episode showed how trust among European countries was fraying.

⁶⁶ Eurostat (n.d.), 'General government gross debt – % of GDP and million EUR'. https://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=sdg_17_40&plugin=1

⁶⁷ Euobserver (2010), 'Brussels rebukes Slovakia over Greek u-turn', 12 August 2010. <https://euobserver.com/economic/30610>

⁶⁸ European Commission (2010), 'Statement by Commissioner Olli Rehn on today's vote by Slovakia's Parliament rejecting the participation in the loan for Greece', 11 August 2010. http://europa.eu/rapid/press-release_MEMO-10-368_en.htm

Enter the troika: the European Commission, the IMF, the ECB

8

In 2010, the monitoring role under the first Greek programme was something new for the European institutions. Not only was the technical support from the IMF important but also its financial involvement.

Jeroen Dijsselbloem

Dutch Finance Minister (November 2012–October 2017),
President of the Eurogroup (January 2013–January 2018) and
Chairman of the ESM Board of Governors (February 2013–January 2018)

Amid the political tremors, it fell to three institutions – the European Commission, the ECB, and the IMF – to engineer, administer, and monitor aid packages, in an informal alliance dubbed the ‘troika’.

While government leaders and finance ministers took overall charge of the policy response, and the euro area rescue fund played an increasingly prominent part, the troika emerged as the public face of the crisis management – and as the target of often vehement criticism in programme countries.

The troika’s origins lay in the circumstances surrounding the ad hoc Greek loan package and the birth of the EFSF. While the Commission and IMF worked out and oversaw economic reforms, and the IMF

co-financed the emergency loans, the ECB focused on banking system stability while keeping an eye on macro-critical developments.

It was natural for the Commission and ECB as EU institutions to share in the crisis management, but the idea of bringing in the IMF took some getting used to. For one thing, the Washington-based lender specialised in rehabilitating less developed economies, not the advanced economies of the euro area.

Some also feared that falling back on outside aid would represent an admission of defeat and further sap confidence in the euro. The counterargument was that euro area stability was a global concern that required global action, and the IMF's technical expertise was universally recognised.

'I had conversations with senior officials in the EU, notably my good friend [then ECB President] Jean-Claude Trichet, who if you remember was very outspoken about keeping the IMF out of Greece,' recalled Lipsky, the IMF's deputy managing director and then acting managing director during the first years of the crisis. 'As he said, it wasn't that he was against the IMF; he wanted the European governments to accept their responsibility.' In Trichet's view, the worst possible situation would have been for the Europeans to ask the IMF to do everything, so as to avoid taking on any responsibility or putting up any money themselves.

In the run-up to the crisis, Europe was already on the IMF's radar screen. 'Early warning' exercises starting in September 2008 flagged the euro area as a potential trouble spot, Lipsky said. The IMF had concerns that 'a financial crisis in one of the peripheral countries, small countries – perhaps Greece – would rapidly infect the major financial markets through commercial banks' balance sheet exposures.'

As early as the spring of 2009, the IMF began making overtures to Ireland, remembers Kevin Cardiff, a senior Irish finance ministry official at the height of the crisis. Ireland then declined IMF assistance, for a number of reasons. One concern was that to seek IMF assistance in isolation would break ranks with the rest of the euro area. 'We couldn't afford to deal with the IMF and alienate the rest of Europe,' Cardiff said. 'We didn't want to move ahead of European policy.'

The IMF had experience in the non-euro EU, most recently coming to the rescue of Hungary in 2008 with loans and a negotiated debt freeze

from commercial banks – but that didn't make its European welcome any warmer when problems in Greece began⁶⁹.

'I was very hopeful that the message would have been learnt that a rapid and credible response was essential,' Lipsky said. 'Instead, as Greek markets began to collapse, the decision was taken to keep the IMF out. The Commission was going to handle the situation all by itself without any mechanism, without a backstop, and with no financial backing. It was very distressing, as it seemed a hugely high-risk strategy was being followed, when better alternatives were available readily.'

Reform programmes designed to regain market access and foster economic recovery are the IMF's core duties, and it offers the added bonus that its refinancing is managed by central bankers and doesn't wind up on the balance sheets of individual member states.

For the first Greek programme, the IMF brought crisis management expertise that, at the time, was in short supply at the EU level, and it provided one third of the rescue loans. The arrangement was transactional, on the expectation that the Greek rescue would be a one-off event.

'At the beginning, the Commission was not equipped to do this job, but they learned very rapidly to do it well,' said Wieser, former chairman of the Eurogroup Working Group.

Debate over the institutional line-up intensified when plummeting markets forced the establishment of the temporary EFSE, and European officials began thinking out loud about a permanent successor. Schäuble, then German finance minister, was initially sceptical about outsourcing some of the crisis management, but was swayed in part by doubts within Germany about the Commission's capacity to impose adjustment programmes along the lines of the IMF's work in Asia or Latin America.

'My own view was that we Europeans should be able to manage this ourselves. But there were certain reservations in Germany,' Schäuble said. 'We came to the conclusion that it would be better if the IMF was involved. After all, people trusted the IMF – it was seen as responsible, reliable, and neutral in the way it interpreted the figures. We wanted to have the IMF on board because its expertise in helping highly indebted

⁶⁹ IMF (2008), 'IMF survey: IMF agrees \$15.7 billion loan to bolster Hungary's finances', 6 November 2008. <https://www.imf.org/en/News/Articles/2015/09/28/04/53/socar110608a>

countries is unrivalled, and because it does not pull its punches when it comes to exposing the need for reforms in these countries.’

The US, the IMF’s largest shareholder, understood the euro area’s effort to keep things in-house. Geithner, former US Treasury secretary, said turning to outside funding sources ‘seemed to me deeply counterproductive to the strategy, which was fundamentally a lack of confidence in Europe’s ability and willingness to solve this.’ A former director of the IMF’s policy development and review department, Geithner said there was an abundance of reasons for Europe to take the lead. ‘Germany’s understandable reluctance to be the sole provider of fiscal resources was not a sufficient reason for the world to deploy resources and to limit Germany’s exposure,’ he said.

Lagarde experienced both sides of the question, as French finance minister at the outbreak of the crisis and then from mid-2011 as the IMF’s managing director. From her perspective, Europe could have contained the crisis independently, had it recognised early on what was brewing and been able to get ahead of the curve.

‘Had we taken that view and convinced [others] a year earlier, the crisis could probably have been solved amongst Europeans and the IMF might have been unnecessary,’ Lagarde said. ‘But where we were, where the markets had pushed Greece, and with the new numbers coming out almost on a monthly basis from Greece, there’s no doubt in my mind that the IMF actually helped address the issue.’

Working within the euro area meant that the Washington-based lender would need to work closely with its European partners. It was a learning experience for all involved, said David Lipton, the first deputy managing director of the IMF. Each institution had decision makers back in its base that it, in turn, would need to work with. For example, the Commission and the ECB had no previous track record with rescue programmes, ‘so there was a process of them gearing up, staffing up and getting experience, and then of course of the different partners learning how to interact with each other,’ he said.

‘It was clear that the rest of the currency zone was going to be playing an important role of support,’ Lipton added. ‘If the troika hadn’t existed we’d have had to invent it – it meant that we had to do business in a different way. It was clear that there was going to need to be a lot of consultation.’

EU policymakers took steps to enshrine the institutional arrangements in setting up the EFSF, stating in the framework agreement that it

is 'envisaged that aid from the temporary fund would be provided 'in conjunction with the IMF'⁷⁰. While the European leadership couldn't speak for the IMF, it became all the more critical to define the institutional division of labour as the discussion shifted to the permanent fund.

On the European side, the objective was to incorporate the IMF's institutional knowledge while avoiding too many constraints on future policies. 'There were some member states in the euro area that very much wanted the IMF to be on board,' said Alexander den Ruijter, an ESM risk officer who was working at the Dutch finance ministry when the crisis struck. 'At the same time they said: "If the ESM is going to be a permanent vehicle, then do we really want the IMF to be always there?" That's a big question. Always means forever.'

Supporters made the case that the IMF would bring objectivity, a crucial selling point given splits among EU policymakers. Because of its global perspective, the IMF was seen as insulated from the kind of political trade-offs that often played a role in European economic policy.

'The participation of the IMF has been quite instrumental in keeping us all on our toes,' Wieser said. 'The design and implementation of a decent adjustment programme simply needs an outside, neutral, and more or less independent institution.'

On the other hand, inviting in outside help raised the concern that the euro area would be giving up some of its autonomy. At one point, the IMF debate became a distraction. During discussions in 2011 over adding to the rescue resources, the European conversation veered towards expanding the IMF's lending capacity, fuelling a perception that euro area leaders were unwilling to confront the crisis head-on.

As the troika took shape, the new institutional landscape wasn't always easy to navigate. Unlike the IMF, endowed with a narrowly defined global mission, the Commission's mandates go far beyond economic policy. It also serves as guardian of the EU treaties, initiator of EU legislation, supervisor of the EU's foreign aid budget, steward of agriculture policy, negotiator of trade agreements, and arbiter of cross-border mergers and acquisitions – to give a far from exhaustive list.

⁷⁰ EFSF Framework Agreement (as amended with effect from the Effective Date of the Amendments), Consolidated version, p. 1, 6 July 2010.
https://www.esm.europa.eu/sites/default/files/20111019_efs_f_framework_agreement_en.pdf

Not all of the Commission's responsibilities coexist smoothly. It treads a complex economic, legislative, and institutional path in applying state aid rules to some governments' capital injections in banks, for example. And, in European policymaking, the Commission often plays a peacemaker role that sits uneasily with a duty to call out and, in some cases, impose sanctions on governments that stray from common European priorities.

Within the troika, the Commission provided economic policy oversight and in-depth analysis on fiscal issues, structural reforms, and macroeconomic imbalances as part of its daily duties. 'We have a long and competent tradition of economic policy surveillance of the countries,' said Rehn, the former European commissioner for economic and monetary affairs and the euro.

Enforcement, however, often runs into political barriers. Under the EU's stability and growth pact, the Commission monitors national adherence to fiscal limits and it can call on a government to correct excessive deficits and debt. But its ability to insist – or impose sanctions if ignored – depends in large part on EU Member States' voluntary submission to the rules. In 2005, EU governments amended the rules, after Germany and France had surpassed the limits in earlier years.

Because of that history, some member states questioned if the EU policy apparatus as it was then constituted would be able to impose sufficient discipline on programme countries. These sensitivities were a major reason why the euro area created an independent firewall, instead of entrusting the Commission with the powers to run a large crisis-fighting budget.

As a result, the Commission was always in the middle of the action, but with its authority circumscribed. In the first Greek programme, the Commission coordinated the bilateral loans that made up the Greek Loan Facility yet worked alongside the IMF.

As Wieser put it: 'I've got great sympathy for this uncomfortable dual role that the Commission has been thrust into, especially in the case of Greece. It simply should not be the role of the Commission to be the sometimes punitive surveying institution, which has to ram through a programme against political opposition in a member state.'

In the end, that responsibility rested with the troika, as directed by the Eurogroup. It wasn't long before the three institutions, yoked together by economic necessity, began to feel the political heat themselves.

Courting a top credit rating: preparing for the markets

9

We spent three months of our lives working with the rating agencies.

Klaus Regling

ESM Managing Director and EFSF Chief Executive Officer

With the creation of the EFSF, euro area member states found an innovative way to support one another, despite the dents in mutual trust. However, before the fledgling EFSF could raise a cent on the capital markets, it needed the endorsements of three large credit-rating companies that advise on what much of the market is willing to buy, sell, and hold: Moody's, Standard & Poor's, and Fitch.

Heading into the second half of 2010, getting the debut credit ratings for the new euro area fund would be the priority for EFSF CEO Regling and Chief Economist Strauch. A top rating was essential to keep issuing costs as low as possible – and to establish a good global reputation.

The rating agencies, which act as a go-between to help investors assess the risks of different issuers, were the central players in this process. For the new and untested EFSF, investors needed the external assurance that only a top rating from the three big agencies would afford. Banks, pension funds, and insurance companies have internal

rules that often forbid investing in debt unless it meets strict rating requirements.

‘It was essential that the EFSF have a good credit rating,’ said den Ruijter, then an officer in the Dutch finance ministry and now one of the ESM’s risk officers. ‘Because the EFSF was going into the market to lend to countries no one else would, it needed to be absolutely credible.’

Obtaining a gold-standard rating, generally known as AAA, is difficult for any borrower because it certifies an issuer as one of the lowest-risk investment propositions. In general, a AAA grade is associated with fiscally sound sovereigns seen as virtually default-proof. Investors who buy highly rated securities receive a promise of safety, and in exchange they accept lower interest returns than they would get by entrusting their cash to riskier endeavours. If the EFSF were to secure a top rating, it could borrow from the markets at low rates.

On the other hand, in creating the firewall, the euro area had set up a new kind of financial structure. Nothing like it had existed before: a private company, with public guarantees from several governments, that issues debt on capital markets to provide loans to countries that had lost market access. The EFSF’s closest equivalent is the EU’s EIB, which also turns to the capital markets to raise funds, but unlike the EFSF has both subscribed and paid-in capital to stand behind its bonds. The EFSF would be borrowing strictly on the strength of euro area guarantees.

‘It was very hard for the rating agencies to understand,’ Strauch said. ‘Also for investors, it took quite some education to get there because it was completely new.’

The novelty meant the rating agencies could not rely on benchmarking against other such organisations, part of their traditional toolkit. They needed to commit time and resources to analysing the new EFSF, which in turn had to explain itself in painstaking detail. It fell to Regling and Strauch to ensure the rating firms understood the mechanism so that the EFSF could get the AAA it sought.

‘Neither Klaus nor I had any primary rating experience, so getting a rating for a new unknown institution that has a complex structure was a challenge,’ Strauch said. The German Finance Agency, which would handle the EFSF’s initial borrowing operations, sent reinforcements. The duo then turned to a US investment bank for advice as they set

about trying to convince the big three rating agencies that the EFSF would be a worthy borrower.

But good advice wasn't enough to get a high-quality rating overnight. 'We went out and tried to get it. We didn't get it in the first round,' Strauch said.

As he and Strauch went back to the drawing board, Regling was fully aware that the EFSF faced more than the usual challenges. And he needed no reminding of the delicate nature of the credit rating situation, having just wrapped up his analysis of the causes of the Irish crisis and the global financial crisis more generally, in which he found fault with the rating agencies for taking a sometimes cavalier approach.

In *A preliminary report on the sources of Ireland's banking crisis*, Regling and Watson, his co-author, spoke plainly: '[...] rating agencies, the custodians of security assessment, dropped their guard, at best.' They added that the core problem was 'their readiness to classify as Triple-A, or close to Triple-A, complex securities based on re-packaged assets'⁷¹. In other words, Regling and Watson had accused the agencies of giving away the AAA rating lightly.

This put the new, untried EFSF in an uncomfortable position when pursuing that same rating. 'That was particularly tricky, because we wanted a AAA after criticising them for two years that they had given away the AAA too easily. They had promised to become stricter, but now we came along saying: "But we are different. We want a AAA,"' Regling said.

The process had two stages: the EFSF had to gain a provisional issuer rating first, and then secure a final rating with the specifics of the security due to be sold. This required an elaborate presentation, along with draft documentation, explanations of the fund's guarantees, and other details of how the programme would work.

⁷¹ Regling, K., Watson, M. (2010), *A preliminary report on the sources of Ireland's banking crisis*, Government Publications Office, Dublin. <http://www.bankinquiry.gov.ie/Preliminary%20Report%20into%20Ireland%27s%20Banking%20Crisis%2031%20May%202010.pdf>

Each rating company had its own procedures. Moody's, for example, outlines a nine-step process that kicks off with a meeting to collect data⁷². This is analysed and condensed into a recommendation made to an internal review board, whose decision is then made public. Follow-up monitoring is continuous. Standard & Poor's has requirements including quantitative and qualitative data, ranging from historical and projected financial information, peer comparisons, governance framework, financial strategy, to the experience and credibility of management⁷³. Fitch carries out yet another approach, looking at the big picture and running various due diligence checks⁷⁴.

As the process got underway, questions poured in from analysts across the rating agencies' departments – structured finance, banking, sovereign ratings, and of course international financial institutions. All sought assurances that requirements in their areas would be met.

'I remember, for example, they would put out the standards for us, the structures for the guarantee mechanism that would be in line with their requirements for some structured finance products,' Strauch said. 'You had to go detail by detail to make it work from their perspective.'

The analysts wanted to know how the EFSF's capital call mechanism would work, the possible time periods involved, each country's individual requirements for being informed, and who should pay what if the capital got called in. It was also important to sort out to whom bond investors could turn in a default and when the money could be collected.

'All that was completely new and had to be reviewed,' Strauch said. The combined effect of negotiating each small detail could get 'very tedious'.

⁷² Moody's (n.d.), 'Ratings process: Moody's process.' <https://www.moody.com/Pages/amr002001.aspx>

⁷³ Standard & Poor's Global Ratings (2018), 'General description of the credit rating process, as of May 16 2018.' https://www.standardandpoors.com/ru_RU/delegate/getPDF?articleId=2053416&type=COMMENTS&subType=REGULATORY

⁷⁴ FitchRatings (n.d.), 'Rating criteria.' <https://www.fitchratings.com/site/criteria>

In particular, the agencies wanted to understand the guarantees from euro area member states that support the EFSF. These guarantees provide assurance to investors that the fund is underpinned by credible sovereign issuers with a long history of reliable public borrowing. The EFSF has no capital of its own – a key compromise in the temporary fund’s design. Instead, euro area member states back the bonds the EFSF issues. And because the member states don’t put up any cash – with the exception of a small start-up contribution – the structure protects euro area taxpayers from direct exposure to the programme countries.

Under the EFSF’s initial design, it had €440 billion in guarantees, equal to its intended lending capacity. This structure paved the way for the EFSF to win approval from euro area governments: the guarantees backed the EFSF’s marketable borrowing, not the loans to the programme countries. It represented a diplomatic coup at a moment when the euro area needed urgent action.

However, as the EFSF approached the markets, the guarantees went under the microscope. Regling explains: ‘The rating agencies wanted to know how strong the legal certainty is. Because if a government after an election in 10 years says, ‘I don’t care what my predecessors did a decade ago. We will ignore these guarantees,’ then the system would collapse. It’s set up in a way that this cannot happen. These guarantees cannot be withdrawn. They are watertight. But this had to be proven, so lawyers from the different rating agencies had to look into the legal systems of each euro area country.’

The initial plan was that all euro area countries would pool their reputations, with the reasoning that any group on this scale, and including so many wealthy countries, would be enough to impress the markets.

But not so fast. Investors quickly deduced that if, say, Portugal was having trouble borrowing on its own, its share of the guarantees wouldn’t count for much. This was one of the first hurdles in the quest for a top rating, which became more of an odyssey than expected.

‘It became clear relatively soon that what we aimed for – AAA – would not fly,’ Strauch said. Under the EFSF’s original design, the initial feedback was not even good enough for an AA-range rating, and that certainly wasn’t going to cut it for the firewall’s debut. At that point, the give-and-take kicked into a higher gear. ‘They give you feedback and say if you want to get an AAA then you need to do these things – and eventually that is what we did,’ Strauch said.

A key problem was that rating agencies would not count guarantees from countries whose sovereign debt was not itself rated AAA towards the EFSF’s AAA borrowing capacity. At the time the EFSF was set up, about 60% of member states had ratings lower than AAA.

‘We had to rethink the structure,’ Strauch said. ‘It all boiled down to the need to get some cash in the box, some assets somewhere to back our issuance.’

The first step to shore up the EFSF’s creditworthiness was for euro area members to increase the size of the guarantees. The countries therefore agreed in June 2010 to guarantee up to 120% of each bond issuance instead of just the face value⁷⁵. This additional guarantee was a step in the right direction but wasn’t enough to satisfy the questions from the rating agencies.

The next step was to add a cash cushion created by extra borrowing, on top of what was needed for programme disbursements. This scheme effectively led to the EFSF retaining about 27% of the cash receipts from the bonds issued. Alongside the member state guarantees, the cash buffer would reassure the markets and act as an effective credit enhancement of the issued bond.

In practical terms, this meant higher costs for countries that entered programmes during this period. The first two countries with EFSF programmes – Ireland and Portugal – had to pay fees and interest on all the cash borrowed on their behalf, not just the amount available to them in disbursement⁷⁶. But, at the same time, the overguarantee structure made it possible for EFSF loans to go ahead.

⁷⁵ Terms of reference of the Eurogroup European Financial Stability Facility (2010), 7 June 2010. https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/misc/114977.pdf

⁷⁶ Cash from the overborrowing (cash reserve) was invested in high-quality liquid debt instruments while retained. The investments and profit and loss results were reimbursed to Ireland and Portugal following the maturity of bonds that funded those loans.

‘It was expensive for the programme countries because you needed to over-issue a lot,’ Strauch said. Nonetheless, an EFSF programme using this approach was still cheaper than the alternative of foregoing the AAA rating, because it allowed the EFSF to tap the market at a lower cost of funding.

As the team put these plans into practice, different models were considered in hopes of finding a technical solution that would meet all of the varied requirements.

Something had to give, and that turned out to be the EFSF’s €440 billion total capacity. The overguarantees would work, but the trade-off was that they reduced the EFSF’s lending capacity to around €250 billion, a lot less than the initial EFSF topline.

‘We amended the structure but at the expense of the volume,’ Strauch said. Only when the member states opted in 2011 to increase the overall guarantees to €780 billion and the overguarantee to 165%⁷⁷ of the issued amount, up from the 120% agreed in 2010, would the fund’s full €440 billion capacity become available.

Former German Finance Minister Schäuble said the guarantee increase became possible after EFSF Members accepted the ‘basic idea’ that Members with an AAA rating assumed some responsibility for the other guarantors. ‘As a result, it was possible to pass on favourable interest rates to the programme countries, which were largely disconnected from the capital markets. This gave them the time they needed to carry out reforms. In that respect, we backed the EFSF model,’ Schäuble said.

As the EFSF evolved, it became less reliant on maintaining a top rating at all times, and the euro area was able to lower the interest rates charged to programme countries. But in the early days, the negotiations to map out the full extension of the guarantee system were needed to start the fund off on the right footing. Later on, the ESM, with its paid-in capital structure, would do away with some of

⁷⁷ EFSF Framework Agreement (as amended with effect from the Effective Date of the Amendments), Consolidated version, p. 7, 6 July 2010.
https://www.esm.europa.eu/sites/default/files/20111019_efs_f_framework_agreement_en.pdf

the limitations inherent in the EFSF's guarantee structure. However, the initial system served its purpose, allowing the EFSF to achieve the rating – and the reputation – it needed to fulfil its mission.

Political and technical compromises in hand, in September 2010 Regling and Strauch secured the best possible provisional first-time credit rating for the EFSF from each of the top three: AAA from Standard & Poor's, Aaa from Moody's, and AAA from Fitch.

- ~ Credit rating history continues in Chapter [29](#).
- ~ For the EFSF's complete rating history, see [Annex – 'EFSF and ESM rating history'](#).

Testing the EFSF: the case of Ireland

10

At some points, we were having a crisis every single day. If you're sick, you can't be. You cannot be absent. Once your banks start to get rocky, it's like a waterlogged boat. Just small little waves might sink you.

Kevin Cardiff

Senior Irish Finance Ministry official (2006–2010)

A potent mix of recession and banking crisis had pushed Irish government finances to the edge. With better bank governance and an eye towards fending off the worst excesses of a boom-bust cycle, Ireland might have been able to avert the debacle. Instead, policymakers not only struggled to tame the excesses, they overextended government finances to rescue the banks amid concerns that failure to support them would have had its own extensive costs.

When Ireland turned to Europe's brand-new firewall, it had already spent two years trying to curb its housing boom and pull its banks onto a more even keel. It was an uphill battle; Irish culture strongly favours home buying, and Ireland had never experienced a widespread real estate bust. On top of that, aggressive banking practices encouraged borrowers to take on ever more credit, in turn saddling the banks with life-threatening levels of bad loans. When the US financial crisis hit in 2008 and sparked global banking turmoil, the Irish banks were especially vulnerable.

1999

1 January

Ireland adopts the euro.

2000
2006

Strong economic expansion driven by construction sector; economy overheats and loses competitiveness.

2007

Construction boom ends and property prices start falling, exposing severe vulnerabilities in the Irish banking system.

2008

30 September

Government issues guarantee for banks' liabilities.

21 December

Finance Minister Brian Lenihan announces plan to recapitalise three main banks: Allied Irish Bank, Bank of Ireland, and Anglo Irish Bank.

2009

15 January

Government announces nationalisation of Anglo Irish Bank after determining recapitalisation is insufficient.

30 March

Standard & Poor's downgrade: AA+ from AAA, the first in a series of downgrades resulting in the July 2011 loss of investment grade.

22 November

National Asset Management Agency Act 2009 becomes law, creating a 'bad bank' that becomes operational in December.

2010

30 September

Lenihan says that banking sector support will cause a 'substantial spike' in the fiscal deficit.

21 November

- Ireland requests financial assistance from the EU, euro area countries, and the IMF.
- EU finance ministers agree to provide assistance through what will become the EFSF's first programme. The €85 billion package – financed by the EFSM with bilateral contributions from Denmark, Sweden, and the UK, including €22.5 billion from the IMF – is formally agreed in December.

2011

1 February

First EFSF loan tranche disbursement (€3.6 billion).

2012

26 July

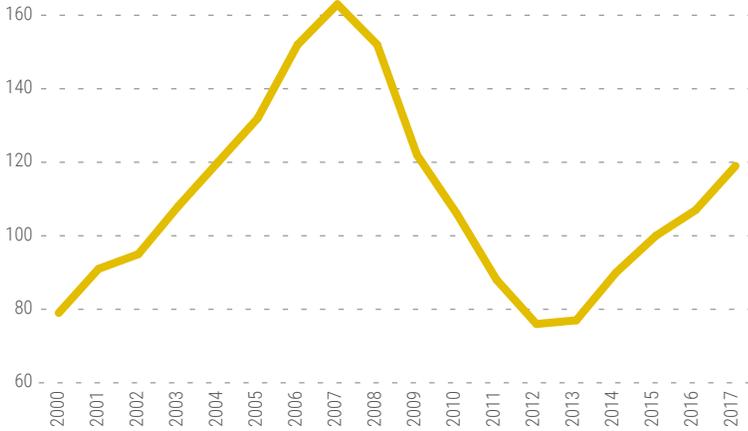
Ireland returns to international capital markets with 5-year bond sale, raising €500 million.

2013

8 December

Ireland successfully exits financial assistance programme.

House price index – Ireland (2015=100)



From boom to bust:
house prices told the tale
of Ireland's economic
fortunes.

Source: Eurostat

In September 2008, in a bid to preserve financial stability the Irish government offered a sovereign guarantee of bank liabilities⁷⁸. *The Irish Times* said that covering up to €440 billion of customer deposits and banks' own lending was 'the biggest financial gamble, and arguably the biggest policy decision, ever taken by an Irish government'⁷⁹. Brian Lenihan, then-finance minister, said the Irish banking sector support would lead to a 'very substantial spike' in the fiscal deficit⁸⁰.

The move made the Irish taxpayer responsible for losses, but even that wasn't enough. In December 2008, the government announced a bank recapitalisation programme, and in January 2009 it nationalised Anglo Irish Bank⁸¹. That November, it rolled out the National Asset

⁷⁸ European Commission, Directorate-General for Economic and Financial Affairs (2011), 'The Economic Adjustment Programme for Ireland', *European Economy Occasional Papers* 76, p. 5, February 2011.

⁷⁹ *Irish Times* (2010), 'The big gamble: The inside story of the bank guarantee', September 2010. <https://www.irishtimes.com/news/the-big-gamble-the-inside-story-of-the-bank-guarantee-1.655629>

⁸⁰ Ireland, Department of Finance (2010), 'Minister's statement on banking 30 September 2010', Press release, 30 September 2010. <https://www.finance.gov.ie/updates/ministers-statement-on-banking-30-september-2010/>

⁸¹ *Irish Times* (2010), 'Anglo Irish Bank – a timeline', 30 September 2010. <https://www.irishtimes.com/news/anglo-irish-bank-a-timeline-1.864923>; *Guardian* (2009), 'Anglo Irish Bank nationalised', 15 January 2009. <https://www.theguardian.com/business/2009/jan/15/anglo-irish-bank-nationalisation>

Management Agency⁸² to tackle the bad-loan backlog and remove the riskiest land and property development loans from the banks' balance sheets.

Ireland's situation triggered debates on when and how governments should step in and who should pay the price for failure. Throughout the crisis, Ireland was under heavy pressure from the ECB and others in the EU to protect senior bank bondholders, who enjoy a privileged position in the payout order in the event of a default. The senior bondholders maintained that advantage even later on, when losses could be imposed on junior creditors as part of the clean-up efforts. Although the ECB had supported the Irish bank guarantees in an October 2008 statement⁸³, Ireland's national guarantee on its banks' obligations came to be seen as a mistake.

Regling and Watson's joint analysis of Ireland's crisis, published in June 2010, found a number of 'home-made' factors that aggravated the impact of the crisis. 'Official policies and banking practices in some cases added fuel to the fire,' the report said. 'Fiscal policy, bank governance and financial supervision left the economy vulnerable to a deep crisis'⁸⁴.

In early May 2010, heading into the crucible weekend that forged the EFSF, markets were requiring high-risk premiums on Irish, Greek, Spanish, and Portuguese debt. Ireland was further slammed by a virtual shutdown in interbank lending among European banks, another sign of a looming systemic crisis. By August 2010, the two-year sovereign bank guarantee was scheduled to expire and bond yields were heading up, while economic growth was slowing. In September, spreads reached a high of 449 basis points, meaning Ireland faced borrowing costs 4.49 percentage points higher than its top-rated euro area peers. Shortly thereafter, new estimates put its total expected bank rescue bill at €45 billion⁸⁵.

⁸² National Asset Management Agency Act 2009, 22 November 2009.

<http://www.irishstatutebook.ie/eli/2009/act/34/enacted/en/html>

⁸³ ECB (2008), Recommendations of the Governing Council of the European Central Bank on government guarantees for bank debt, Frankfurt, 20 October 2008.

http://www.ecb.europa.eu/pub/pdf/other/recommendations_on_guarantees.pdf

⁸⁴ Regling, K., Watson, M. (2010), *A preliminary report on the sources of Ireland's banking crisis*, p. 43, Government Publications Office, Dublin. <http://www.bankinqury.gov.ie/Preliminary%20Report%20into%20Ireland%27s%20Banking%20Crisis%2031%20May%202010.pdf>

⁸⁵ BBC (2010), 'Irish deficit balloons after new bank bail-out', 30 September 2010.

<https://www.bbc.com/news/business-11441473>

Then, on 18 October 2010, German Chancellor Merkel and French President Sarkozy took a walk on the beach in Deauville, France, and emerged with a handshake agreement that private investors shouldn't be immune from losses in future sovereign debt crises. This meant that losses for creditors and investors, often called 'haircuts', could become de rigueur if euro area countries found themselves with unsustainable debt and in need of aid. The deal was struck as part of a broader agreement⁸⁶ between France and Germany that aimed to improve the bloc's budget rules as well as its rescue mechanisms.

The idea of enshrining debt restructuring in perpetuity sent shockwaves across the world's bond markets, which have traditionally treated sovereign debt from developed countries as low-risk, or even risk-free, investments. In a 27 October speech to the Bundestag, Merkel explained that the Deauville compromise included plans to make bondholders, such as banks and hedge funds, share some of the costs of risky lending by sharing responsibility for coming to the rescue of states on the brink of insolvency. For France, the subject of an EU 'excessive deficit' procedure from 2009 to 2018⁸⁷, agreeing to 'adequate participation of private investors' – that is to say, writedowns – was the price of securing a German retreat from a proposal to apply automatic sanctions to countries that flouted the rules of the stability and growth pact, according to observers⁸⁸.

'The compromise was an awkward one: France agreed to start discussions on a German demand for a permanent crisis resolution framework ensuring that private creditors would share the burden of debt restructuring. In exchange, Germany renounced the idea of automatic sanctions for countries in violation of the fiscal discipline provisions of the stability and growth pact,' wrote Jean Pisani-Ferry, a former policy advisor to the French government, in his 2014 book, *The euro crisis and its aftermath*⁸⁹.

⁸⁶ France, Germany (2010), 'Franco-German declaration: Statement for the France-Germany-Russia Summit', 18 October 2010. https://www.eu.dk/~media/files/eu/franco_german_declaration.ashx?la=da

⁸⁷ European Commission (2018), Recommendation for a Council Decision abrogating Decision 2009/414/EC on the existence of an excessive deficit in France, COM(2018) 433 final, 23 May 2018. https://ec.europa.eu/info/sites/info/files/economy-finance/com_2018_433_en.pdf

⁸⁸ See, for example, Spiegel Online (2010), 'EU agrees to Merkel's controversial euro reforms', 29 October 2010. <http://www.spiegel.de/international/europe/brussels-summit-eu-agrees-to-merkel-s-controversial-euro-reforms-a-726103.html>; or *Financial Times* (2010), 'Franco-German bail-out pact divides EU', 24 October 2010. <https://www.ft.com/content/56984290-df96-11df-bed9-00144feabd0c>; or Brunnermeier, M., James, H., and Landau, J.-P. (2016), *The euro and the battle of ideas*, Princeton University Press, p. 1. <https://press.princeton.edu/titles/10828.html>

⁸⁹ Pisani-Ferry, J. (2014), *The euro crisis and its aftermath*, p. 10, Oxford University Press, Oxford.

Financial markets were jolted by the debt-restructuring element of the deal. Some policymakers said it added to contagion woes in the euro area.

‘The Deauville deal came unexpectedly. It showed that premature and spontaneous talk on debt restructuring can be very damaging to the credibility of the euro zone in financial markets,’ said Rehn, at the time the European commissioner for economic and monetary affairs and the euro. ‘When the Deauville deal was done it was lose-lose, both in terms of watering down the sanctions and in terms of prematurely and spontaneously raising the possibility of a debt restructuring.’ Trichet, then-ECB president, said that at the EU summit of 28 and 29 October 2010 he had opposed the Deauville agreement, because it would be understood as an open invitation to speculate.

Government borrowing rates skyrocketed in Ireland, where the government’s balance sheet had ballooned, and the banks were receiving unsustainable levels of emergency support from the central bank. The Deauville deal directly put Ireland on the path to losing its market access, said Trichet. It also added to the re-pricing of risks that had already started in the markets. Investors began differentiating among euro area countries as never before, with a particular focus on countries that had accumulated large economic imbalances. Taken together, these developments amplified the contagion that would push Ireland into a rescue programme within weeks.

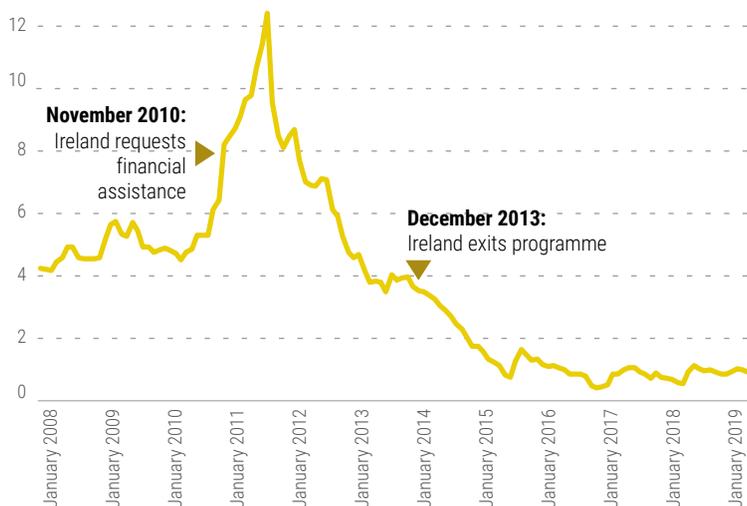
‘People tend to forget,’ Rehn said. ‘It was not evident that Ireland had to go into a programme. Probably they would have, but we don’t know that.’

On 4 November 2010, Ireland announced record budget cuts of €15 billion⁹⁰, but the yield on its 10-year bonds rose anyway to average a punishing 8.22% that month. Spreads to the 10-year German Bund widened that day to 526 basis points. At such elevated levels, sovereigns typically refrain from long-term issuance. The ECB also began putting pressure on Dublin to seek broader assistance.

⁹⁰ Ireland, Department of Finance (2010), ‘Information note on the economic and budgetary outlook 2011-2014’, Press release, 4 November 2010.
<http://www.finance.gov.ie/updates/information-note-on-the-economic-and-budgetary-outlook-2011-2014-in-advance-of-publication-of-four-year-budgetary-plan/>

10-year government bond yield – Ireland

in %, monthly average



Ireland's bank-rescue bill and broader concerns over potential euro area debt restructurings precipitated a rise in Irish interest rates at the height of the crisis, but Ireland then benefited from a good track record under the programme.

Source: European Central Bank

At this point, Irish banks were heavily dependent on the ECB's tool for solvent financial institutions that are experiencing temporary cash flow problems, Eurosystem emergency liquidity assistance. Trichet later said that the total liquidity supply coming from the Eurosystem to Ireland was the largest in the euro area, surpassing 100% of Irish GDP.

On 19 November, Trichet wrote to Lenihan to say the ECB would not continue to augment the emergency liquidity it had been providing unless Ireland sought a rescue programme⁹¹. Two days later, the government gave in.

'I would like to inform you that the Irish Government has decided today to seek access to external support from the European and international support mechanisms,' Lenihan wrote to Trichet on 21 November. He called it a 'grave and serious decision'⁹².

⁹¹ ECB (2010), Letter written by Jean-Claude Trichet to Brian Lenihan, reclassified for publication on 6 November 2014, 19 November 2010. https://www.ecb.europa.eu/press/shared/pdf/2010-11-19_Letter_ECB_President_to%20IE_FinMin.pdf?31295060a74c0ffe738a12cd9139f578

⁹² Ireland, Department of Finance (2010), Letter written by Brian Lenihan to Jean-Claude Trichet, reclassified for publication on 6 November 2014, 21 November 2010. https://www.ecb.europa.eu/press/shared/pdf/2010-11-21_Letter_IE%20FinMin_to_ECB_%20President.pdf?432af7ba36b71099b55893b819ae2502

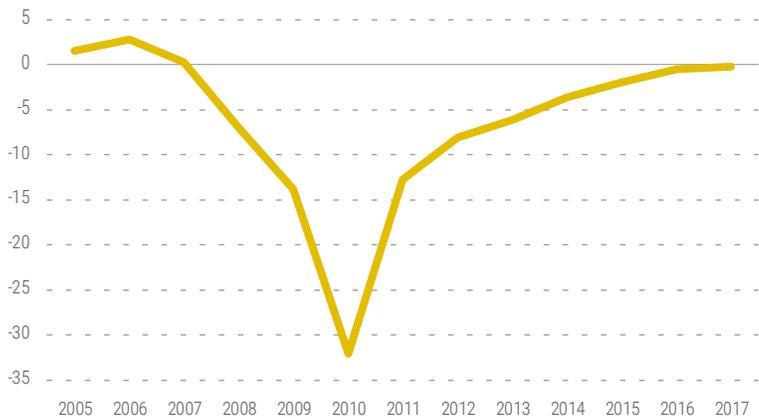
The same day, the IMF said it stood ready to join in the rescue effort. EU and euro area finance ministers also put out a statement saying they were prepared to move ahead, pledging to finalise the deal in early December⁹³.

EU finance ministers officially approved the agreed rescue package at their 6 and 7 December meeting⁹⁴. The package envisaged €85 billion in assistance, of which Ireland itself provided €17.5 billion. Others delivered the remaining €67.5 billion, including €17.7 billion in loans from the fledgling EFSF⁹⁵, whose board assented on 21 December following the IMF.

In exchange for international assistance, Ireland pledged to shrink its banking sector, tighten financial regulation, rein in public spending, and enact structural reforms aimed at boosting growth. Specifically, the Irish agreed to open up service sectors that had been protected, and also to pursue wage adjustments in a bid to make the country more competitive.

General government fiscal balance – Ireland

in % of GDP



Ireland racked up enormous deficits in providing aid for its overindebted banks.

Source: Eurostat

⁹³ Statement by the Eurogroup and Ecofin Ministers, 21 November 2010.

https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/117898.pdf

⁹⁴ 3054th Council meeting Economic and Financial Affairs, Press release, No. 333, 7 December 2010.

https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/118290.pdf

⁹⁵ Council Implementing decision on granting Union financial assistance to Ireland, Interinstitutional file, 2010/0351(NLE), 7 December 2010.

<http://data.consilium.europa.eu/doc/document/ST-17211-2010-INIT/en/pdf>

From the start, Irish authorities were determined to show the international community that they were serious about overhauling their economy. ‘Ireland has proved so far to be flexible and aggressive in dealing with its problems and will continue to be so,’ Lenihan said in his letter to Trichet⁹⁶.

In the days leading up to the programme, Irish officials fought hard to make sure the reforms required were things they could deliver.

‘All the incentives are to pre-negotiate as much as possible,’ said Ireland’s Cardiff, at the time one of Lenihan’s senior deputies. ‘In fairness, the other side also wanted that because the one thing no one wanted was that you’d have a promise that there would be a deal and then it couldn’t be finalised. That could be terrible.’

In the run-up to the aid negotiations, Ireland had sought to keep its distance from the IMF in order not to spook investors. It could negotiate with its euro area peers on the sidelines of regular meetings, but direct talks would have signalled that Ireland was in need of a rescue package and therefore on the brink. ‘The IMF was like a little explosive, once you introduced the name into a conversation,’ Cardiff said. If IMF officials came for a special meeting, ‘then that became a signal to the market of some sort.’

This signalling was especially significant because Ireland would become the first country to seek aid under the new EFSF firewall system. The country might have benefited from looking to outside help sooner – in 2017, an evaluation report of EFSF and ESM activities found that Ireland could have requested a programme as early as April or May 2009 – but at that time there was no euro area mechanism in place.

In Cardiff’s view, Ireland had every incentive to wait until the outlines of the deal would be clear to make its request for aid. Otherwise international officials might have pressured Ireland to make changes out of step with Irish economic priorities, Cardiff said. ‘People really want to help, but they’re also policymakers with administrations behind them, and people are saying, “We waited 10 years to have a moment when we could ask for this, that, or the other.”’

⁹⁶ Ireland, Department of Finance (2010), Letter written by Brian Lenihan to Jean-Claude Trichet, Reclassified for publication on 6 November 2014, 21 November 2010. https://www.ecb.europa.eu/press/shared/pdf/2010-11-21_Letter_IE%20FinMin_to_ECB_%20President.pdf?432af7ba36b71099b55893b819ae2502

The final negotiations came down to just a few days in mid-November. As Cardiff describes it: ‘We were trying to say what would be in the programme. I remember being on the phone back to Dublin to the minister saying: “After trying hard I finally have a list. It’s not that ambitious, we might actually do more than they’re asking.” Our own list of economic conditionality was a bit bigger than the proposal.’

By this point, Regling had built the core of his firewall and was laying the groundwork for the EFSF’s financial market debut. Cardiff remembers him at a euro area finance ministers meeting just before the deal went through – present, but keeping a low profile, in conformity with the EFSF’s initial technocratic design.

Ireland proved a test case for the rescue model on a number of fronts. It faced relatively high interest rates from the EFSF because the consensus at the time was that support programmes should be a last resort to be quickly exited, and therefore made economically relatively unattractive. The IMF provides loans at shorter maturities with interest rates also geared towards encouraging programme exit. But euro area countries later twice adjusted their approach, offering in 2011 and 2013 an easing of loan terms to Ireland and Portugal, once it became clear that high borrowing costs hindered rather than helped the countries’ efforts to restore access to financial markets.

As the programme progressed, Ireland became a positive case study for the euro area model of providing conditional financial assistance to countries in need. The Irish 10-year government bond yield, which had peaked at a monthly average of 12% in July 2011, would steadily decline through 2012, giving the Irish authorities some breathing room. In the first half of 2012, the Irish debt agency resumed selling short-term paper on the financial markets. In July 2012, the Irish debt agency sold its first bond, and since then the country has made a point of rolling over existing debt and managing its budget so that it has close to a year of financing on hand at all times.

Irish programme (2010–2013)

-  **Initial programme amount:** €85 billion, including Irish national funds of €17.5 billion
-  **Total amount disbursed:** €67.5 billion, of which the EFSF provided €17.7 billion, the EFSM/EU €22.5 billion, the IMF €22.5 billion, and Denmark, Sweden, and the UK €4.8 billion
-  **Lenders:** EFSF, EFSM, bilaterals, IMF
-  **Final weighted average maturity (EFSF loans):** 20.7 years
-  **Key legislated reforms:** financial sector strategy (downsizing, reorganisation of banking sector); strategy to restore fiscal sustainability (reducing expenditure, tax system reform, generation of additional revenue); structural reform package

‘We wanted to deal with our own situation,’ Cardiff said. ‘There was, at that point at least, determination in the government to address the problems fully. There was no one trying to say “let’s do half a job here.”’

Wieser, former chairman of the Eurogroup Working Group, agreed that the Irish recognised that they were authors of their own misfortune. The programme largely covered the financial reforms they themselves knew needed implementing. ‘With one or two extremely important exceptions, the programme design followed very much the Irish economic policy restructuring plans, which they themselves had drawn up,’ Wieser said. ‘It is more a matter of the political system and the sociological conditions in a country whether there is the perception of being against the wall or not. If you look at the five different programme countries, in Ireland there is the highest degree of perception that they were instrumental themselves in causing this mess.’

Ownership was present in Ireland from the rescue’s beginning. *The Irish Times*, in an opinion piece on 18 November 2010, in the end stage of the negotiations, echoed Greek resentment at the need to request outside aid, but also recognised domestic responsibility for what had happened. ‘We have surrendered our sovereignty to the European Commission, the European Central Bank, and the International Monetary Fund. [...] The true ignominy of our current situation is not that our sovereignty has been taken away from us, it

is that we ourselves have squandered it.[...] It is the incompetence of the governments we ourselves elected that has so deeply compromised our capacity to make our own decisions⁹⁷.

The EFSF disbursed the first tranche of €3.6 billion to Ireland at the start of February 2011. Setting a pattern for other aid recipients, Ireland made its first cautious return to market financing during its programme, in July 2012, with a 5-year bond sale that raised €500 million⁹⁸.

‘That sense of ownership was essential to Ireland’s eventual success with its programme,’ said Chief Economist Strauch. Ireland also benefited from its willingness to engage fully with the global economy, which led to a strong economic recovery once it had overcome the worst of the crisis, Strauch said, adding: ‘That’s basically because Ireland is a small, open economy. Once you’re over what was really a bubble, then you can grow fairly rapidly.’

By sticking to its economic commitments, Ireland was able to make a clean exit from its rescue programme in December 2013. A year later, it repaid the first tranche of its IMF loans ahead of schedule. By March 2015, it had completely repaid the most expensive part of its IMF assistance, roughly €18 billion in loans that had been scheduled for repayment between July 2015 and January 2021⁹⁹. By 2018, it had repaid the IMF in full, as well as Denmark and Sweden¹⁰⁰.

Schäuble, the former finance minister of Germany, paid tribute to Ireland’s success. ‘Ireland has successfully downsized and consolidated its bloated banking sector and is now one of the EU’s most dynamic economies once again.’

⁹⁷ *The Irish Times* (2010), ‘Was it for this?’, 18 November 2010.

<https://www.irishtimes.com/opinion/was-it-for-this-1.678424>

⁹⁸ Ireland, National Treasury Management Agency (2012), ‘NTMA announces bond switch and outright sale’, 26 July 2012.

<https://www.ntma.ie/news/ntma-announces-bond-switch-and-outright-sale/>

for a fuller assessment of how four programme countries approached the restoration of market access, see Strauch, R., Rojas, J., O’Connor, F., Casalinho, C., de Ramón-Lapa Clausen, P., Kalozois, P. (2016), *Accessing sovereign markets: The recent experiences of Ireland, Portugal, Spain, and Cyprus*, ESM, Discussion Paper 2, 20 June 2016.

<https://www.esm.europa.eu/sites/default/files/esmdp2final.pdf>

⁹⁹ Ireland, National Treasury Management Agency (n.d.), ‘EU/IMF programme summary’.

<https://www.ntma.ie/business-areas/funding-and-debt-management/other/eu-imf-programme>

¹⁰⁰ Ireland, National Treasury Management Agency (2017), ‘NTMA completes further €5.5 billion early repayment of EU/IMF programme loans’, 20 December 2017.

<http://www.ntma.ie/news/2017/12/20/ntma-completes-further-e5-5-billion-early-repayment-of-euimf-programme-loans/>

A phone, a laptop, and an espresso machine: start-up culture

11

It felt like we were flying a plane while we were still building the engine.

Kalin Anev Janse
ESM/EFSF Secretary General

A small suite of old-fashioned offices provided the firewall's first home. Even those were a step up from Regling's personal laptop and telephone, which constituted the fund's entire infrastructure for his first weeks as chief executive in June 2010. When Regling was hired, the EFSF existed on paper only. The rescue fund needed to be built from the ground up, under intense time pressure.

'My contract started on the 1st of July, but I basically started working in the middle of June, just going back and forth between Brussels and Luxembourg,' Regling recalled.

After the decision was taken to base the EFSF in Luxembourg, Regling's next task was to rent an office. The EIB, which had offered set-up help, suggested one of its nearby facilities. But the space was larger than the new firewall needed, so Regling protested: 'It's too big! I will only take half of it and pay half the rent.'

The EIB agreed, but 18 months later it handed over the other half of the space as the EFSF's responsibilities expanded.

EFSF staff and service providers in 2011, a year that ended with two countries in programmes and a third on the way.

Credit: ESM archives



Those first offices sported blue carpet and wood panelling, harking back to stodgy 1970s interior designs for bureaucracies. Apart from the dated décor, the office wasn't so bad, said Denise Franzen, one of the original dozen pioneers and the EFSF's first office manager. But getting space was only part of the struggle of setting up a new entity. Conference rooms are useless without people to meet in them, and more colleagues needed to make it to Luxembourg, too.

In the early days, the EFSF resembled a hastily set-up campsite. Minor irritations were the order of the day. At times, Regling was left on his own to search for the last remaining cream for his coffee, and someone had to find out how to order new supplies. It turned out to be crucial that the EFSF's first 'investment' was a sturdy espresso machine, which is still performing its duties to this day.



Coffee, anyone? One of the EFSF's first purchases was an espresso machine. Managers regard it fondly, given its help in keeping them awake during those long nights early on.

Credit: ESM

At the time, Franzen was doing everything from purchasing coffee and settling invoices to paying out salaries to the burgeoning staff and reviewing speeches for the head of press relations. Regling would check in on how things were going, but he was on the road so much that most of the planning fell to Franzen and the skeleton crew holding the fort. 'It was challenging and interesting. Everything had to be in place more or less immediately. I cooperated closely with Klaus's personal assistant, and, because we had such good understanding about what needed to be done, things ran smoothly despite a rapidly changing environment.'

That informality came with perks and costs. Françoise Blondeel, now a management board member, said the new EFSF had to press ahead with few set procedures in place on such things as budgeting, choosing suppliers, and other logistical matters.

'Because we were new, we had fewer internal rules to comply with,' said Blondeel, who ran the rescue funds' middle and back office when she joined in early 2012. 'But we always adhered to the highest professional standards. In those early days, the middle and back office team put in a lot of hard work, with high-quality results, despite their small numbers.'

Precision and professionalism are hallmarks of the ESM. Here, members of the middle and back office team process and review transactions.

Credit: ESM



The initial goal was to make the temporary firewall as lean as possible, with a staff of only a dozen. In addition to the challenge of finding the right people for those spots, they needed phones, computers, desks, and office space. More importantly, this small team needed to be ready for its mission. That meant building the appropriate operating chain, including choosing, following a fair and competitive tender, the right bank and other financial suppliers to process the flow of funds in a fast and secure manner as well as establishing the appropriate information technology infrastructure to record those flows correctly. It also entailed defining and negotiating legal agreements that would protect the interests of the institution.

One of Regling's first hires was Sarah Fouqueray-Carrick, a French-speaking Briton with a background in private sector asset management. Fouqueray-Carrick had just resigned from a French firm to set up a translation business that would require less travelling and allow more time with her small children.

'I had just taken the summer off and I was in the process of setting that up and, out of the blue, a friend of a friend contacted me saying, "Are you interested? They want someone with a marketing/communications background who can write well in English," Fouqueray-Carrick recalled. She responded that she'd just stepped back from intensive work because it was too chaotic and interfering with family life. The friend of a friend

told her not to worry. ‘You can work part time because, actually, you may have nothing to do.’ With those famous last words, she became employee number four, off to rattle around the EFSF’s first suites.

‘We occupied just a small corner of the building; the rest was all empty,’ she said. ‘It was this big corridor with empty rooms, and then this big empty space at the end.’

It soon became clear that writing for the EFSF would require her to be quick on her feet. On Fouqueray-Carrick’s first day, she was asked to complain about an article that appeared in a major UK newspaper. ‘That was my first task, to write a stern letter to the author to say he was incorrect on many points.’ Letter dispatched, she began to take a more systematic look at how the EFSF would keep in touch with staff and stakeholders while its top leaders were educating the markets and the media about its bonds. Her core duties of communications and investor relations became paramount.

‘Klaus Regling and [CFO] Christophe Frankel were out on the road all the time meeting investors,’ Fouqueray-Carrick recalled. ‘That was the best policy: to make sure people were as informed as possible and to make ourselves available. We were taking calls night and day from journalists, because there were so many rumours swirling and it was very important to get the factual information out to them.’

To keep the messages straight, the firewall hired a German journalist to deal with the press. He set up a regular conference call to coordinate with the European Commission, the ECB, and other key institutions, making sure all the organisations were taking the same line. ‘That was just a basic thing, but it was really important,’ Fouqueray-Carrick said. ‘He established quite quickly the discipline of coordinating what was said.’

Investors noticed, too, said Frankel, which reinforced the decision to put communications at the top of the in-house agenda. ‘That’s why a communications specialist was one of the first hires,’ Frankel said. ‘It was obvious that good communications were crucial to the success of this company, for various reasons: communication towards investors, the press, shareholders, the IMF, and the other institutions.’

Not only did the EFSF have to win over the bond markets, it also had to keep up with its new peer group of international financial institutions. ‘They had to see us as a peer, but we were initially perceived as the new kid on the block who was still learning,’ Secretary General Anev Janse said.

The rescue fund is still small enough for the entire staff to meet weekly, to discuss the upcoming agenda and give feedback to management.

Credit: ESM



As with all start-ups, everyone had to be a jack of all trades, and tasks were carried out – at first – in an ad hoc manner. As the organisation grew, the EFSF added weekly staff meetings in 2011 to make sure important details didn't get lost in the shuffle. These continue today. 'Having a better global overview of what was upcoming in the new institution improved our daily work,' Franzen recalled. 'With the weekly staff meeting I knew what to expect the coming week.'

As the firewall staff grew, its mandate provided both recruitment incentive and ongoing motivation, said Sofie De Beule-Roloff, head of human resources and organisation. 'Here at the ESM/EFSF you feel very involved in the mandate and its social contribution to Europe – it's not just a distant concept you see on the television news,' she said. 'Even those teams not in direct contact with our programme countries feel constantly connected and involved in the mission. This engagement and connectivity is exactly what drives our people and what makes them go the extra mile over and over again.'

🌀 Institutional history continues in Chapters [21](#), [28](#), and [30](#).

‘Make sure the project flies’: the EFSF’s first bond

12

We needed to strike the bullseye first time around, because during those tumultuous days there could be no near-misses.

Christophe Frankel

ESM/EFSF Chief Finance Officer and
Deputy Managing Director/Deputy Chief Executive Officer

Once the EFSF secured a provisional AAA rating from all three big-name rating firms, it was primed to go to the markets if needed.

In the months before Ireland’s formal request, the EFSF team prepared for what could be coming, lining up investors and clearing a number of obstacles. But, when Ireland did apply for rescue loans in November 2010, with cash needed quickly, the firewall had to pick up the pace to get its first-ever programme ready to go.

‘The first “surprise” was when we went from being a firewall that would never be tapped to one that was actually going to be tapped,’ said Chief Economist Strauch. ‘That piled on the pressure. We shifted from the orderly mode of getting the rating, arranging the mechanics, up into a higher gear with a clear and urgent deadline.’

Frankel, CFO of the EFSF and head of the roadshow team for the inaugural sale, agreed. 'The rush came when Ireland formally asked for assistance at what seemed to us very late in the process.'

Starting with a fresh slate brought new challenges. For one thing, the euro fund didn't have instant name recognition. Bond markets were also getting used to the EU's emergency fund, the European Financial Stabilisation Mechanism, or EFSM, set up the same weekend as the EFSF and also designed to help members with market access problems. And there had been a French entity called the Société de Financement de l'Économie Française, or SFEE, now defunct. But the EFSF stood for something new and different.

'The names didn't help. But at the same time, it was good that we had to explain things to investors,' Frankel said. 'It was a way for us to make sure that everyone really understood the new organisation and how it worked.'

On the plus side, the new entity had some weighty backers. These included all euro area member states, which were its shareholders, and the German sovereign's funding arm, the German Finance Agency, which had agreed to process its market operations. The German agency's imprimatur offered immediate institutional credibility, along with the secondment of its senior funding expert, Thomas Weinberg. By outsourcing its funding operations, the EFSF ensured they would be in experienced hands. Weinberg, well known and trusted in the markets, would run the borrowing team in its initial stages.

It was a critical moment. As an issuer that stood for the entire euro area, if the EFSF could not raise the funds when needed, it would set a disastrous precedent.

For the original team, the watchword for the EFSF project was: 'Make sure the project flies.'

Weinberg had the start-up team move quickly, even though in mid-2010, shortly after the EFSF emerged in May, it did not look as if there was an imminent need to go to market.

By summer 2011, Weinberg had assembled a team of four people, two fellow German Finance Agency staff, Siegfried Ruhl and Silke Weiss, and two outside hires. These included a staffer from Greece’s debt agency, Francis Dassyras, as well as a US citizen, Glenn Kim, who would be the first of dozens of non-EU nationals to work at the rescue fund.

The core Luxembourg team of Regling, Strauch, and Frankel had to lay the groundwork for the new funding team to take up their mission. From the start, the EFSF team had to be prepared on multiple fronts: in addition to the all-important rating, they had to work through a range of technical, legal, and regulatory issues essential to gaining access to the right investor base.

For example, the EFSF, together with the German Finance Agency’s front office team, had to make sure the mechanics of the sale would work. Its bonds had to be compatible with clearing systems and stock exchanges in the major markets. In addition, the securities would need to be eligible for repurchase agreements throughout the market, and for ECB transactions. They would also need a good risk weighting so banks and other institutional investors would have an incentive to stock up for their portfolios. ‘We had to knock on different doors to explain what the EFSF is and to explain to the various regulators that they should give the EFSF bonds the lowest weight possible,’ Frankel said.

Against this backdrop, the call to action prompted an orderly rush. Frankel said he had been ‘quite confident’ that the EFSF would be able to tap the markets. But when Ireland made its move to seek assistance, on 21 November 2010, the team had to make a big push. Frankel said investors had ‘considerable confidence’ in the set-up from the start.

There were a number of elements that needed deciding: what day to hold the sale, which banks would assist, size of the deal, maturity of the issue, fixed- or floating-rate coupon, yield at issuance in comparison with peers, and how the debut issue would be marketed to prospective investors.

For the banks, a lead role with the first issue of the EFSF would be not only financially lucrative, but also prestigious. For the EFSF, finding banks to act as bookrunner for the first transaction was ‘a lengthy but fascinating process,’ Weinberg said. The EFSF needed to work with banks that had a strong track record of support for first-time issuers.

Metrics were assembled. A major factor was banks' experience in carrying out euro-denominated transactions. The EFSF team probed how the banks ranked in their home countries' primary bond markets, how they were viewed in terms of service and market information, and their experience in primary markets outside their home countries. Once that information was collected and assigned weightings, Weinberg's team went through the long list of league tables, searching for banks with experience of bringing a new issuer to market.

For the banks that had worked with inaugural sales before, did those kick-off transactions go well and were they recent enough to be relevant? If so, those banks drew relatively high scores heading into the next round. In the final step, the German Finance Agency's EFSF team listened to more than two days of presentations, in which candidate banks outlined their pitches to the EFSF and the finance agency, with the entire team judging. The shortlist contained just a handful of firms.

'We tried to develop a system that was completely independent from political influence. That was important to us, because we feared very much that senior bankers would contact politicians to try to get a mandate or get a bookrunner role,' Weinberg said. In his view, 'the process was a success.' The firms it chose as the EFSF's first bookrunners were Société Générale, Citibank, and HSBC¹⁰¹: a French bank, a US bank, and an Asian-British bank. 'And I thought, Yes, strong banks, no worries. I slept well after that.' The banks were chosen on 17 January 2011, one week before the sale.

To smooth the process of going to the market for the first time, Frankel's goal was that he and Regling should meet as many investors as possible in their sales push. They held three roadshow conferences in Frankfurt, Paris, and London in October 2010. On the technical side, the EFSF made a great impression. But the big picture worried some. 'Of course, there were some doubts about whether we would be strong enough or big enough in case a large European country asked for assistance,' Frankel said.

For Ruhl, Weinberg's right-hand man on the funding team, the key would be making sure investors were comfortable with the EFSF's complicated and novel guarantee structure. 'Marketing would have

¹⁰¹ EFSF (2011), 'EFSF mandates Citi, HSBC, and Société Générale as joint lead managers for the inaugural benchmark issue', 17 January 2011. <https://www.esm.europa.eu/press-releases/efsf-mandates-citi-hsbc-and-soci%C3%A9te-g%C3%A9n%C3%A9rale-joint-lead-managers-inaugural-benchmark>

to be extremely good to explain the relatively difficult structure to the investor base in order to get them to buy possible bonds,’ said Ruhl, who runs the rescue funds’ funding and investor relations operations. But on the plus side, the EFSF was emblematic of how the currency union had come together in the face of its biggest challenge to date. ‘There was so much strong political will behind the creation of the EFSF,’ he said. ‘The EFSF stood for the euro area. That more than outweighed any difficulties in explaining the complex guarantee structure.’

Some 500 prospective investors were called. They had different reactions. ‘You had some saying ‘okay, you have a good rating, you are a new institution, we will open lines immediately.’ Others would come to you saying “let’s talk again when you are ready to issue and we will see at that moment whether it makes sense for us to open a line,”’ Ruhl recalled. ‘What was important was that everyone was aware of the creation of this body, was aware that it was very good and had strong member state backing.’

When the time came to ramp up in earnest, the EFSF team reached out to the European Commission and its emergency fund, the EFSM, to make sure the two mechanisms wouldn’t inadvertently compete, either through timing or by issuing securities that were too similar.

‘We coordinated on how to approach the market once it was clear that Ireland wasn’t able to raise its own funds,’ Weinberg said. In the end, the Commission went first, selling a €5 billion bond on 5 January 2011¹⁰².

As the EFSF’s first bond sale approached, the credit-rating companies were due to give their final ratings. Fortunately, they confirmed their earlier decisions to award the firewall their top qualification. In a 19 January 2011 press release following the confirmation¹⁰³, Regling said: ‘We expect investor interest to be high as our debut issue provides a good opportunity for investors to diversify into a new supranational and liquid asset.’

¹⁰² European Commission (2010), ‘€5 billion bond issue for Ireland’, Memo, 5 January 2010. http://europa.eu/rapid/press-release_MEMO-11-4_en.htm

¹⁰³ EFSF (2011), ‘Top credit rating for EFSF’s debut debt issuance’, Press release, 19 January 2011. <https://www.esm.europa.eu/press-releases/top-credit-rating-efsf%C2%80%C2%99s-debut-debt-issuance>

Did investors understand the whole structure? Maybe not entirely in those early times. But the EFSF's top credit rating provided reassurance, and there were plenty of investors looking for investment alternatives in euro-based assets.

Once the transaction started, the EFSF team could monitor the electronic order book to see the size and price of buy orders. The team tracked the building demand with growing wonder. 'The order book showing on our PCs within a few hours was unbelievable,' Weinberg said. 'By evening it was clear that we would have a successful transaction.'

The final pricing was made the following day: on 25 January 2011, the EFSF placed a 5-year €5 billion bond with the price fixed at mid-swap plus six basis points, implying borrowing costs of 2.89%. Total demand for the bond was €44.5 billion, or about nine times the available amount¹⁰⁴.

'We were all very positively surprised when we received a €45 billion order book for a €5 billion transaction,' Ruhl said. 'Usually if you receive order books in the size of €7, €8, €9, €10 billion for a €5 billion transaction, that would be good, so €45 billion was quite a high number.'

In one sign of success, the new firewall withstood the full scrutiny of the Japanese finance ministry. If Japan had had any concern about an instrument, it would not have invested, said the IMF's Furusawa, who served in his country's finance ministry when the EFSF was making its market debut. He said Japan saw the EFSF as a solid opportunity. From a return-on-asset perspective, it was guaranteed by the entire euro area. More than that, the Japanese were firm supporters of the collective initiative. The product was safe, but the international cooperation was a weightier consideration.

'We bought 20.5% of the total first issue. That was certainly the largest purchase in the world at that time,' Furusawa said. 'We felt that it was in the interest and the benefit of the international community to avoid the European crisis becoming a global crisis.'

¹⁰⁴ EFSF (2011), 'EFSF places inaugural benchmark issue', Press release, 25 January 2011. <https://www.esm.europa.eu/press-releases/efsf-places-inaugural-benchmark-issue>

Weinberg attributed the success to the EFSF’s marketing efforts: ‘Klaus Regling and Christophe Frankel did a superb job with the marketing.’

In Frankel’s view, the first transaction was a triumph not only because the marketing was well handled, but also because the maturity was standard and the market was in a good mood. It turned out that the pricing, decided in cooperation with the issuing banks, was quite favourable as well. There had been some uncertainty over what kind of premium investors would demand, especially since it wasn’t clear then how big an issuer the EFSF would become. There are trade-offs between liquidity, price, and volume; if a small programme sold a large volume of securities, it could have been tricky.

‘You want to be conservative, but not too conservative,’ Frankel said. ‘In the end, when you see that kind of oversubscription, you can be very satisfied because it shows that the preparation was well done.’

This initial bond sale was ‘quite a historic exercise not only because it was the first EFSF transaction but also because of how it went,’ Ruhl said. ‘There was a lot of uncertainty regarding the future of the euro, and therefore how the EFSF would be accepted.’

Focus

A precedent-setting disbursement

Once the EFSF sold its first bond, its next technical challenge was sending the money to its proper destination. To disburse the funds to Ireland a week later, the new firewall needed access to the 24-hour secure global communication network used in the exchange of international payment instructions, the Society for Worldwide Interbank Financial Telecommunications, better known by its acronym SWIFT.

Shortly before the transfer, Chief Economist Strauch approached Fernando Rodriguez, the EFSF's 13th hire and first and then sole in-house funding expert. He joined the day of the inaugural bond offering, only to face his first challenge almost immediately. Strauch asked, 'Do you have any experience in the back office and settlement of payments within the SWIFT system?'

'None at all,' Rodriguez, who would become advisor funding and investor relations, said he responded. 'So Rolf put a huge pile of folders with documentation on my desk and said: "Okay, you now have one week to read all these and to set up the necessary arrangements to be able to make the payment."'

'It was really painful,' Rodriguez admitted. 'But we all knew that we were part of something big, something that we would always remember.'

The disbursement went through on 1 February 2011. Despite the stresses, Rodriguez said the experience was intensely rewarding. 'For me, on a personal level, to be able to say to my children, I was the guy that made the first payment to Ireland and established the pattern for the financial assistance through this mechanism – that's something no one else can say.'

 Funding strategy continues in Chapters [14](#) and [18](#).

The crisis spreads to Portugal: a second call for aid

13

In November 2010 it became apparent that the crisis was not confined to Greece. It was spreading. I grew increasingly convinced that Portugal would soon need to follow Ireland in asking for support.

Fernando Teixeira dos Santos
Portuguese Finance Minister (July 2005–June 2011)

With Ireland and Greece in programmes, Portugal drew the focus of market attention. Its bond yields were already at critical levels in the spring of 2010, and the question became: would Portugal be next?

Albuquerque, who would later become Portuguese finance minister, was at the time leading the issuing department of the country's debt management office. From that post, she could see the crisis threatening to engulf Portugal's shores.

'When we talk about contagion, it is of course always the most fragile or the most vulnerable that cause the biggest concern. Portugal was clearly in that situation,' she said.

1999

1 January

Portugal adopts the euro.

2008

GDP begins falling; economy suffers from low productivity, eroding competitiveness, rising unemployment, and large external deficit.

2009

21 January

Standard & Poor's downgrade: A+ from AA-, the first in a series of downgrades resulting in the eventual loss of investment grade.

2011

23 March

Parliament rejects government's reform measures.

24 March

José Sócrates' socialist government resigns but remains in a caretaker capacity.

29 March

2010 deficit reaches 8.6% of GDP, above the 7.3% target.

7 April

Portugal requests financial assistance from the EFSF, the EFSM, and the IMF.

16 May

Eurogroup and Ecofin agree to provide financial aid to Portugal. Of the total €78 billion, the EFSF, the EFSM, and the IMF commit to €26 billion each.

5 June

Pedro Passos Coelho announces he will form a coalition following elections that prompt Sócrates' resignation.

22 June

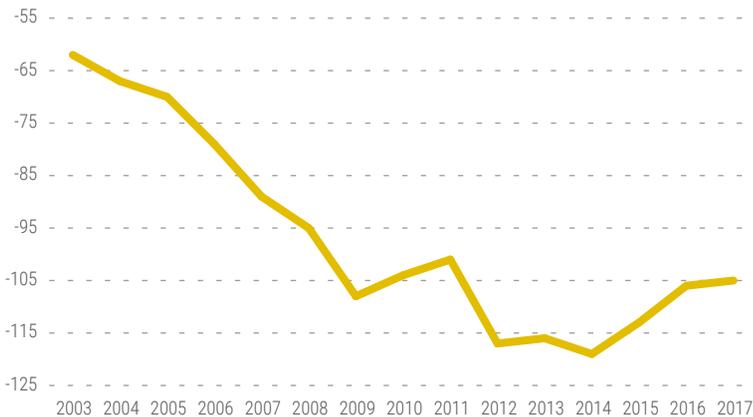
First tranche of €3.7 billion is disbursed.

Portugal's economy had been ailing for some time, with low GDP and productivity growth in the 10 years before the crisis¹⁰⁵. Because of the low interest rate environment across the euro area following the adoption of the euro, credit had been easily available, contributing to rising debt levels for companies, households, and the government. With wage growth outpacing productivity gains, Portuguese products became more expensive abroad, contributing to a deceleration in export growth and a loss of competitiveness.

Banks were an additional weak link in the Portuguese chain. Investors worried that the Portuguese financial sector was overly exposed to the struggling economy, which in turn made the country even more susceptible to economic shocks. As interbank lending dried up across the euro area, the Portuguese banks resorted to central bank financing. That strategy couldn't last indefinitely.

Net international investment position – Portugal

in % of GDP



Portugal's net international investment position declined in the run-up to the crisis, a sign of the economy's weakening competitiveness and current account imbalances.

Note: GDP is not seasonally adjusted in this chart.

Source: Eurostat

¹⁰⁵ European Commission, Directorate-General for Economic and Financial Affairs (2011), 'The Economic Adjustment Programme for Portugal', *European Economy Occasional Papers* 91, p. 5, June 2011. http://ec.europa.eu/economy_finance/publications/occasional_paper/2011/pdf/ocp79_en.pdf

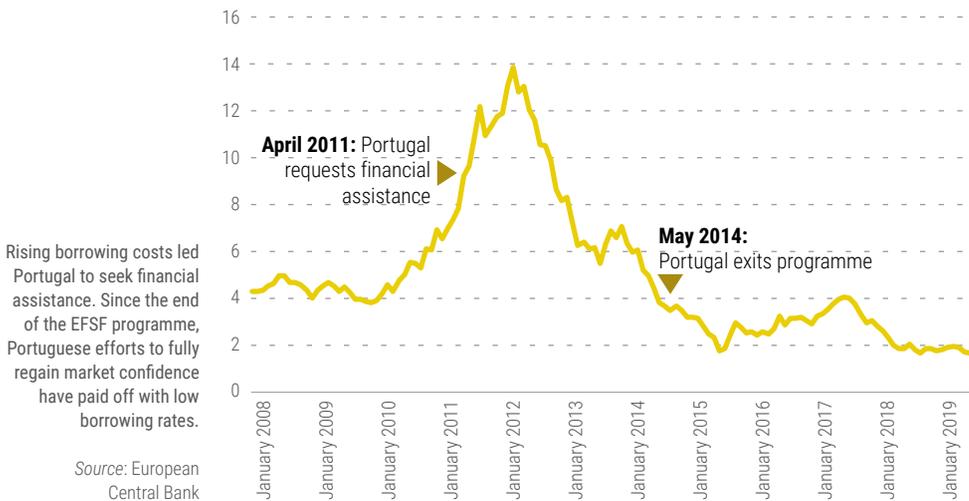
With a deficit that would, after multiple revisions, reach a record 11.2% of GDP in 2010¹⁰⁶, Portugal didn't have much fiscal room to tide its economy over or respond to market pressure. As the budget news got worse, bond yields increased sharply from April 2010, hitting what the government perceived as critical levels as it rose above 10% by mid-2011.

'The sense of urgency became clear,' said Fernando Teixeira dos Santos, who was finance minister from 2005 to 2011.

Fitch had cut Portugal's long-term debt to AA- from AA in late March 2010¹⁰⁷, the first in a series of downgrades resulting in the late 2011 loss of investment grade¹⁰⁸. The successive cuts would spook markets further, leading to an even more rapid deterioration of the spreads. Yields on the 10-year bond would average 13.9% in January 2012, levels well beyond the point at which market access becomes unsustainable. Portugal's domestic troubles had become caught up in the euro area's broader spiral of contagion.

10-year government bond yield – Portugal

in %, monthly average



¹⁰⁶ Eurostat (n.d.), 'General government deficit (-) and surplus (+) – annual data', 2006–2017.

<https://ec.europa.eu/eurostat/tgm/table.do?tab=table&plugin=1&language=en&pcode=teina200>

¹⁰⁷ MarketWatch (2010), 'Portugal downgraded to AA- by Fitch', 24 March 2010.

<https://www.marketwatch.com/story/portugal-downgraded-to-aa-by-fitch-2010-03-24>

¹⁰⁸ Bloomberg (2011), 'Portugal's credit rating is cut to junk by Fitch on debt', 24 November 2011. <https://www.bloomberg.com/news/articles/2011-11-24/portugal-s-credit-rating-cut-to-junk-by-fitch>

Still, authorities in Lisbon initially resisted asking for help. Gaspar, who served as Portuguese finance minister at a later stage of the crisis, said any country that might need international aid runs up against a ‘stigma effect’ in the eyes of the market. ‘There is definitely not an immediate boost to credibility associated with having a programme,’ he said.

Teixeira dos Santos said the IMF’s role in particular was an incentive not to seek aid, because of lingering resentment from two prior programmes in 1977 and 1983.

‘Policies were very restrictive. Recession, high unemployment, high inflation, declining real incomes, and a deterioration of living conditions at the time became associated with the IMF,’ he said. ‘Calling the IMF again would be like, for a child, calling for the “bogyman”. Such memories implied it would impose a very high political cost. No wonder there was reluctance.’

This stance led to some tense moments in the Eurogroup’s Task Force on Coordinated Action, recalled Albuquerque: ‘I remember being in meetings where people said things like “we need to find a way of setting these programmes without stigmatising the countries involved because that leads to political resistance to admit that there are problems.” A roomful of people would look straight at me and someone would say “because there are countries that really need help but refuse to admit it.”’

In the end, it took a political crisis for the Portuguese programme to come together. José Sócrates’s Socialist government made a last effort in mid-March 2011 to win over the markets by pledging a deeper overhaul of the budget, with the support of the European Commission and the ECB¹⁰⁹. But less than two weeks later, this reform package failed in the Portuguese parliament, prompting the minority government to resign and step into a caretaker role until after new elections¹¹⁰.

¹⁰⁹ European Commission (2011), ‘Joint statement by the European Commission and the European Central Bank on the measures announced by the Portuguese government’, 11 March 2011. http://europa.eu/rapid/press-release_MEMO-11-164_en.htm

¹¹⁰ European Commission, Directorate-General for Economic and Financial Affairs (2011), ‘The Economic Adjustment Programme for Portugal’, *European Economy Occasional Papers* 79, p. 15, June 2011. http://ec.europa.eu/economy_finance/publications/occasional_paper/2011/pdf/ocp79_en.pdf

By the end of March 2011, ‘it was not possible to go to the market for funds,’ said Albuquerque. ‘They were just too expensive and, from a certain point onwards, non-existent. It stops being a vague question of crisis. It becomes an immediate non-availability of the markets to lend.’

The deficit for the previous year was revised upwards to 8.6% of GDP, above the 7.3% target¹¹¹. A few days later, at the start of April 2011, Portugal faced unsustainably high interest rates, with yields on the benchmark 10-year bond at 9%. Crunch time had arrived. On 7 April, the caretaker government asked for assistance from the EFSF, the IME, and the Commission’s emergency fund, the EFSM.

‘The newly formed EFSF was keeping an eye on developments as it managed its own debut,’ said Chief Economist Strauch. As he remembers it, the process of encouraging Portugal to seek a programme evolved over time, until the outgoing government was forced to confront how tight market conditions had become. The start-up EFSF had only a small part in the preliminary discussions, he said. Its role ramped up once the programme was underway.

Portuguese politicians still trade accusations about the delay in asking for a programme. For Teixeira dos Santos, his government’s last-minute proposals were an effort to work with the institutions in a ‘precautionary way, to head off the need for a full aid programme and outside funds,’ while also trying to bypass what he called ‘the stigma associated with seeking a bailout.’ Albuquerque says the caretaker government was merely delaying the inevitable. ‘So it came late – it should have been done earlier.’

In 2017, the EFSF/ESM programme evaluation report concluded that an earlier request would have saved Portugal money. ‘Official requests for assistance came with considerable delay. Since countries must initiate requests for a financial assistance programme, such delays had financial and political consequences for the government,’ the report said¹¹².

¹¹¹ Ibid.

¹¹² Tumpel-Gugerell, G. (2017), *EFSF/ESM financial assistance: Evaluation report*, Publications Office, Luxembourg. https://www.esm.europa.eu/sites/default/files/ti_pubpdf_dw0616055enn_pdfweb_20170607111409_0.pdf

At the same time, conditions in 2010 and 2011 discouraged early requests for help.

The EFSF was engineered so that programme countries would face high interest rates, just as Greece's first, pre-EFSF rescue programme had come with high borrowing costs. The purpose was to avert the moral hazard of encouraging some countries to indulge in poor budget and debt management, thinking they could always resort to the firewall. These higher rates were revisited in 2011, but they were very much a part of the early design.

There was also a heavy political cost to seeking aid, and a worry that markets would attack any country viewed as entering the early phases of that discussion. As Teixeira dos Santos said, the perception in potential recipient countries is that 'the stigma was and still is big.'

It took euro area countries over a month – until 16 May – to formally approve Portugal's aid request¹¹³. In discussions at EU-level meetings, Albuquerque found feedback to be constructive but also tough. Portugal needed to own up to how things had got so bad and commit to repairing the situation, she said. Rebuilding credibility would be essential to keeping EU support.

Portugal's package – the second for the euro area's new firewall – covered up to €78 billion in financing, split three ways between the EFSF, the EFSM, and the IMF. To get the programme underway, both the EFSF and the EFSM had to overhaul their financing calendars immediately, in order to raise the money for the initial disbursement within a matter of weeks.

¹¹³ European Commission (2011), 'Portugal: Memorandum of understanding on specific economic policy conditionality', 17 May 2011. http://ec.europa.eu/economy_finance/eu_borrower/mou/2011-05-18-mou-portugal_en.pdf

Portuguese programme (2011–2014)

- Initial programme amount:** €78 billion
- Total amount disbursed:** €76.8 billion, of which the EFSF provided €26 billion
- Lenders:** EFSF, EFSM, IMF
- Final weighted average maturity (EFSF loans):** 20.8 years
- Key legislated reforms:** fiscal consolidation; structural reforms; stabilisation of the financial sector (recapitalisation and deleveraging)

The package allowed Portugal to pay its immediate bills and recapitalise its banks. In return, Portugal agreed to bring down its budget deficits, fix its banks, and modernise its economy. The IMF and EU institutions required stepped-up banking supervision and a front-loaded set of structural reforms designed to encourage growth and make the country more competitive. In particular, Portugal was called on to reduce unit labour costs, increase working hours in the public sector, make labour market rules more flexible, and update its housing and service sectors. The programme also sought judicial reform. Budget cuts were necessary, but Portuguese authorities were encouraged to head off possible public upset by designing tax increases and benefit cuts in a way that would minimise their impact on the lowest-income groups.

Nominal unit labour cost – Portugal

(2010 = 100)



Portugal began to restore its economic health when it reduced labour costs, improving competitiveness. After the programme, labour costs increased again and some of those gains were reversed.

Source: European Commission

On 5 June 2011, the Socialist Party lost an election that delivered a big win to the Social Democratic Party. The coalition government of Prime Minister Pedro Passos Coelho embraced the economic rebuilding plan. Gaspar, the new government's first finance chief, says the climate had defrosted considerably by his first meeting with other ministers from euro area countries in July 2011. 'I was received quite warmly. At that point in time we had already presented our strategy for the implementation of the programme and that was very well received,' Gaspar said.

It helped that public opinion in Portugal was in favour of the adjustment programme. 'When the programme implementation started, the degree of consensus on the need for adjustment in Portugal was absolutely overwhelming,' Gaspar said. 'The parties that won the elections and formed the government had supported the earlier Socialist government in the process of the negotiation. During the campaign, they said clearly that they would, if elected, implement the programme in a committed and, they thought, successful way. And obviously the Socialist Party that had negotiated the programme campaigned on exactly the same broad approach. That led to a situation where, at the beginning of the programme, almost 90% of the parliament supported it.'

In the beginning, the euro area rescue fund focused more on Portugal's funding needs than on whether or not it was fulfilling its programme conditions. Later in the programme, the firewall took a bigger role in technical talks. Albuquerque remembers the team as constructive and careful not to get in the way of its fellow institutions. 'There was never a time, at least as it was reported to me, where the ESM raised an issue completely different from the European Commission,' she said.

Strauch said Portugal showed early signs that it might have the political will to work through its difficulties. There was a spirit of optimism that the euro area was finding the right tools to navigate the crisis after the assistance programme for Ireland was agreed.

And, in contrast to the dreary weather of Ireland – where the deal was finalised on a snowy day in Dublin, in a basement room of the attorney general's office with bars on the windows – the Portuguese sunshine gave a lift to morale.

'In Portugal, we went to the ministry and it was a warm sunny day when we started negotiating the financing agreement,' Strauch said. 'Despite the grave situation for the country, it made it feel more manageable in that moment.'

 Portuguese programme history continues in Chapter [32](#).

Scaling up the fund: the 'save Europe' call

14

If you have the right people and empower them in a challenging environment, you create an atmosphere where highly motivated staff innovate.

Siegfried Ruhl

ESM/EFSF Head of Funding and Investor Relations

Programmes for Ireland and Portugal sent a signal that the new rescue fund would have to scale up. Chief Economist Strauch said the lending and funding structure devised in the beginning was an auspicious start. The expansion started a bigger discussion about what changes might be needed for the long run. The EFSF's original plan was to raise money on a per-disbursement basis, but over time it might need to shift its strategy towards a more consistent relationship with the markets.

Chief Finance Officer Frankel said the EFSF knew the overwhelming demand for its first bond offering would not be a regular occurrence. Still, that initial performance was a great reassurance as the team worked to improve the temporary firewall.

'It was quite a busy time for 11 people!' he said. 'We were satisfied that the mechanism worked and could be used again, even if we knew that the nine-times oversubscription would not happen again.'

As concerns grew that other countries might also need help, thoughts turned increasingly to revamping the initial lending and funding structure, Strauch said. ‘We started seeing that the initial financing framework and resources envisaged for the EFSF might not be sufficient and might have to be changed – particularly in case other countries were to follow.’

Because the EFSF’s debut transaction had a 5-year maturity¹¹⁴, it probably wasn’t a good idea to go back to the same segment of the market right away. So the EFSF began considering shorter or longer: a 1-year, 2-year, 3-year, or 10-year issue. The timing was tight, but the EFSF was ready to fund its share of the €78 billion programme once the Eurogroup agreed to provide assistance, on 16 May 2011. The EFSF’s contribution was €26 billion and the first disbursement was due less than a month later. The EFSF went to the market for the second time on 15 June 2011, with a €5 billion 10-year bond. With this issue, the ‘temporary’ EFSF could now be counted in decades.

Overall, the second sale succeeded, but on a more down-to-earth scale than its predecessor. The order book came in around €8 billion with participation from nearly 100 institutional investors¹¹⁵, about a third of which were central banks and sovereign wealth funds. The EFSF was off to a great start, but, over time, the short turnarounds would become increasingly difficult. At times, ‘it was difficult to raise the money and the price we had to pay was relatively high,’ Frankel said.

Strategy discussions focused on long-term funding. ‘It was terrific that the first bond sale had been such a success, but the second, third, and fourth ones needed to work too,’ said Weinberg, the German Finance Agency expert who led the initial EFSF funding programme. The new firewall and its eventual permanent successor had to figure out in the short run, where to approach the market next, and, in the long run, how to establish the right reputation with the kinds of investors the euro area needed.

To some, the Luxembourg arrangements seemed a little, well, odd. Jürgen Klaus, a long-time trader who became a funding officer at the rescue fund, said he remembered thinking to himself: ‘What is this private company, this *société anonyme*, that is located next to a shopping mall in Luxembourg?’

¹¹⁴ EFSF (2011), ‘EFSF places €5 billion bond in support of Portugal’, Press release, 15 June 2011.

<https://www.esm.europa.eu/press-releases/efsf-places-%E2%82%AC5-billion-bond-support-portugal>

¹¹⁵ Ibid.

At first, those assigned to the EFSF within the German Finance Agency kept a professional distance from their colleagues. The agency created a separate division for its EFSF office to make sure everything was in order.

‘We analysed whether a separation from the activities executed for Germany was necessary from a compliance perspective and came to the conclusion that it was necessary because of one aspect,’ Weinberg said. After the EFSF began to issue in January 2011, ‘every launch of a bond transaction required some investments. Because the colleague who was responsible for EFSF investments needed to be able to buy German government securities, we had to put up a Chinese wall between him and the German government securities traders.’

In the beginning, EFSF borrowing was ‘not very flexible. We stuck to certain maturities in the first few issues. We were a very small team,’ said Silke Weiss, another funding officer. And the German agency naturally operated with a domestic, not an international, outlook, unlike the EFSF, where English was the working language.

When Dassyras joined the EFSF team from Greece in June 2011, it was the first time the German Finance Agency had hired someone who didn’t speak German. ‘Since I could speak English, I was asked if I could help him,’ Weiss recalled. ‘I bought him a Greek-German dictionary to get him started.’

The EFSF’s debt management pioneers worked late, ordered in pizza when needed, and tried hard to handle all the demands of a two-location start-up. ‘It was maybe not the ideal set-up, but in the beginning it was easy enough to communicate,’ Frankel said. ‘There were not so many transactions, so it was not so much of a burden to go to Frankfurt for the transactions at the start.’

As the pace picked up, the outsourcing period wound down and the whole operation moved to Luxembourg. Weiss later transferred permanently to the ESM from the German Finance Agency. ‘It felt like the rescue funds were something that would be with us for a long time,’ she said.

Weiss said the need to consolidate became evident as the EFSF required access to more maturities and a generally more flexible approach, so the start-up funding team began designing a system that could grow with the institution. ‘Everything in Luxembourg was still in the making so we had to coordinate somehow with them, while being in Frankfurt.’

The team set up a fixed timeslot for a conference call, Mondays at 17.00, lasting anywhere from 15 minutes to an hour. ‘We called it “the save Europe call,”’ Weiss said. She recalled the small core in Frankfurt coordinating with Luxembourg, and sometimes the European Commission. ‘We talked about the market, upcoming transactions, and the sequencing of the transactions of the European Commission’s emergency fund, the EFSM, and those of the EFSE.’

João Gião, a former ESM/EFSE legal officer, who joined from the Portuguese securities regulator, said the public service aspect made the long hours tolerable and created a feeling of belonging. ‘When I moved here, I certainly thought I was on a mission. You kind of feel a special sense of reward,’ Gião said. ‘When you have to work late, you do it not with the goal of getting a bonus at the end of the year, but because you are trying to solve a problem that will improve lives, or at least make them less hard.’

In May 2012, the funding team started commuting, spending Monday to Wednesday in Luxembourg and flying back to Frankfurt to finish the working week. By then, the original four-person German finance group funding team had been joined by an experienced trader, a senior business analyst, and an information technology specialist who would make sure the EFSF could work smoothly with the finance agency systems.

Klaus thought of it as the ‘Breakfast Club’: Dassyras, Gerhard Hannoschöck, Klaus, Thomas Ritter, Ruhl, and Weiss. Ruhl, who had become head of the EFSF front office division and was Weinberg’s right-hand man, remembers 12- and 14-hour days that ended up in a hotel across the street from the office. Weiss said that the 18.55 Wednesday flight was her weekly commuting milestone.

Over time, being on-site gained more importance as member states began requesting assistance and the EFSF developed new tools beyond basic aid loans. Funding Officer Rodriguez said there were ‘intense negotiations’ to get staff to commit to relocating during this period, which eventually succeeded, even if some staff kept up a weekend commute afterwards. ‘It was not easy for them or for us, but it got progressively better in terms of settling them definitively in the institution.’

As the relocation to Luxembourg approached, Klaus had his turn to see the market in a new way. He was called on to investigate what physical set-up the rescue fund could use for conducting transactions,

down to picking out the furniture. He sought out his old private sector colleagues, but not for what they expected. ‘I visited trading floors in Frankfurt – I went to my former employer in search of practical info,’ he said. ‘To my former colleagues’ surprise, I showed up asking to speak to the facility manager. They would say “Really?” and I would say “Really. I would like to have a look at what kind of desks you have.”’

Later on, the middle and back office team worked together to organise the clearing and settlement of the ESM’s paid-in capital investments. While the team managing the capital executed such trades, the mechanics were handled by a US bank, and, when this was being set up in 2012, there was much discussion about whether or not the euro area’s firewall should depend on firms from outside the area to clear its transactions.

But the core goal was to make sure the EFSF and ESM could function when the markets themselves weren’t working correctly, which meant using the best providers for the job. Those early days were marked by many calls with Germany’s Bundesbank, the ECB, and a European international central securities depository providing post-trade services to arrange all of the necessary payment connections.



A look inside the EFSF and ESM trading room. Operations were originally split between Luxembourg and Frankfurt, but as the rescue fund grew, the entire trading staff was relocated to Luxembourg.

Credit: ESM

As the EFSF grew into the ESM, it became more important for all of its staff to be under the same roof. For Weinberg, who chose to stay at the German Finance Agency, this meant making sure his team was ready to take its data, technology systems, and team spirit to their permanent home. ‘We supported them as much as we could at that point in time,’ Weinberg said. ‘It was important for me personally that they could be transferred to Luxembourg as a whole group.’

The ESM took over the contracts of the funding team in January 2013, ending the formal link to the German Finance Agency. Since then, the funding team has more than doubled in size, and specialists in investor relations have been added. The focus has shifted to how to help the institution mature now that the pressing needs of the early days have ceded ground to new pressures to develop more versatile strategies and analytical products. Still, the core of the team has been the veterans who were present from the start. In the end, the ESM was able to import its entire team from the German agency, allowing the firewall to grow without losing the critical knowledge gained in its first two years.

‘I have never experienced a team spirit like the one here in the German Finance Agency’s EFSF team,’ Weinberg said. ‘I had a feeling of the flow, like a runner’s high. If you are running along and are lucky you get into the flow. You feel that everything is moving effortlessly, and it gives you such a sense of satisfaction.’

 Funding strategy, which began in Chapter 12, continues in Chapter 18.

Towards the ESM: 'a solid legal foundation'

15

Europe went into this without any consensus, no established arrangements, no constitutional mechanism and no tools for managing a meaningful funding problem. Europe definitely had a much, much bigger challenge than we did. I've got a lot of sympathy for how tough that was.

Timothy Geithner

US Treasury Secretary (January 2009–January 2013)

As the EFSF began operations and financial markets continued to test the euro area, there was a growing awareness that a temporary rescue vehicle would not be enough. The mantra that 'a crisis is a terrible thing to waste' became a common refrain, voiced by politicians and commentators alike.

Few saw the hastily set-up EFSF, with its guarantee-based structure, as the model for a new, permanent institution. Its lack of independent financial capacity made its fundraising vulnerable to volatile market moods, and the EU statistical authority classified the guarantees as Member State debt¹¹⁶, putting a burden on national finances. The

¹¹⁶ Eurostat (2011), 'New decision of Eurostat on deficit and debt: The statistical recording of operations undertaken by the European Financial Stability Facility', Press release, 27 January 2011. <https://ec.europa.eu/eurostat/documents/2995521/5034386/2-27012011-AP-EN.PDF/25064294-4cae-4b50-a447-60165ca9718d?version=1.0>

temporary fund represented what was politically feasible in May 2010, not what was economically desirable over the longer term.

‘The EFSF was set up as a temporary institution. It would be better to have something with the same mandate and the same instruments, but organise it differently as an international institution and a permanent one,’ said Chief Executive Regling.

High-level impetus for a permanent crisis mechanism had already come in with the Deauville understanding between Chancellor Merkel of Germany and President Sarkozy of France in October 2010. But there would be no repeat of the rushed establishment of the EFSF. For one thing, the immediate crisis seemed to retreat in late summer and early autumn 2010.

More importantly, given the legal challenges filed in Germany against the ad hoc euro area rescue policies, a permanently endowed fund had to first be anchored in EU law.

‘Once the EFSF was established, what was important was to then move to the next step and create something that would be more robust and more credible,’ Malta’s Camilleri said. ‘It was important that we create an institution that was robust for the longer term.’

A discussion started over whether or not to amend the Treaty on the Functioning of the European Union, especially in the light of the Article 125 provision, which makes it illegal for a Member State to ‘assume the commitments’ of other members. Commonly known as the no-bailout clause, Article 125 was intended to dissuade countries from running up excessive debts.

EU leaders endorsed the idea of a permanent fund at an October 2010 summit and addressed the broader legalities in December 2010, when they composed an amendment to Article 136 of the EU Treaty¹¹⁷. This text affirmed that a stability mechanism could be established by the Member States ‘if indispensable to safeguard the stability of the euro area

¹¹⁷ Conclusions of the European Council meeting (2010), CO EUR 21, CONCL 5, 17 December 2010. <http://data.consilium.europa.eu/doc/document/ST-30-2010-INIT/en/pdf>;
All euro member states ratified the amendment in time for the ESM’s introduction in October 2012, but the amendment didn’t enter into force until 1 May 2013 following final ratification by the Czech Republic. See European Parliament (2013), Article 136 TFEU, ESM, Fiscal Stability Treaty, Ratification requirements and present situation in the Member States, 11 June 2013. http://www.europarl.europa.eu/meetdocs/2009_2014/documents/afco/dv/2013-06-12_pe462455-v16_/2013-06-12_pe462455-v16_en.pdf

as a whole¹¹⁸. It meant that both the ESM and conditions for its use were reflected in primary law, the EU's founding treaties. Financial aid under the mechanism, the amendment said, would be subject to economic and financial reforms, also known as strict conditionality.

The ESM was thus infused with a hybrid legal character. It was clarified that the permanent firewall was compatible with the EU Treaty, by virtue of the amendment, but set up outside the EU framework as an agreement among euro area governments. Gaspar, a former finance minister of Portugal who now heads the IMF's fiscal affairs department, said the decision to go the intergovernmental route instead of founding a fully fledged EU institution expedited the set-up.

'If you had tried to do it inside the European Union machinery involving the creation of a new institution through a treaty change, that would have taken much, much longer,' Gaspar said.

One outcome of this strategy was tighter control by national governments, said Buti, the European Commission's director-general for economic and financial affairs. 'The feeling was also that through an intergovernmental approach, Member States and parliaments had more of a grip on this and a capacity to stop,' Buti said.

Germany's former Finance Minister Schäuble said the treaty amendment facilitates the provision of financial aid without violating the no-bailout clause. 'The newly added article¹¹⁹ explicitly clarifies that it is permissible for the euro area member states to provide each other with financial assistance, as a last resort to ensure the stability of the currency union and only under strict conditions,' Schäuble said. 'These kinds of exceptional situations do not represent a violation of the no-bailout rule. Hence the ESM Treaty is based on a solid legal foundation.'

In the first half of 2011, decisions on the shape of the ESM took place against a fraught political and economic backdrop. Greece's economy continued to deteriorate, making an additional injection of aid likely, while Ireland and Portugal had embarked on their own programmes.

¹¹⁸ EU (2011), European Council decision of 25 March 2011 amending Article 136 of the Treaty on the Functioning of the European Union with regard to a stability mechanism for Member States whose currency is the euro, OJ L91/1, 6 April 2011.
<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32011D0199&from=EN>

¹¹⁹ EU (2012), Consolidated version of the Treaty on the Functioning of the European Union, OJ C326/47, 26 October 2012, Article 136(3).
<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:12012E/TXT&from=EN>

‘There was a perception, or the understanding, that some countries were just too big for the EFSF capacity and that we needed to find something more robust to handle what would come in the future,’ said Albuquerque, who also served as Portuguese finance minister.

At first, the permanent fund was conceived of as a more smoothly functioning offspring of the EFSF. Its key operational features, sketched out by Eurogroup finance ministers in November 2010¹²⁰ and finalised at a European summit on 24 and 25 March 2011¹²¹, resembled the EFSF’s capabilities at the time. The ESM was to be equipped with two instruments – lending to distressed member states based on a full macroeconomic adjustment programme, and primary market bond purchases – with a pricing structure that mimicked the EFSF’s¹²².

In that early conception, aid decisions would have been by unanimity and the ESM would have enjoyed preferred creditor status over private sector bondholders, two features that triggered criticism.

What set the ESM apart was the use of paid-in capital instead of the EFSF’s guarantees. Euro area member states would contribute €80 billion upfront¹²³. The funds were initially to be transferred in five annual instalments, starting with the ESM’s planned launch in July 2013. Euro area leaders also agreed on an additional €620 billion in ‘callable’ capital to be contributed when requested, giving the ESM a total subscribed capital base of €700 billion.

‘What is interesting, as a footnote to financial history, is that we created a unique mechanism for calling capital,’ said Verwey, a senior Dutch finance ministry official at the start of the crisis who is now with the Commission. ‘It deviates from everything that had been done before with financial institutions. We more or less automated it. From a rating perspective, this provides more security that the capital will indeed be there.’

¹²⁰ Statement by the Eurogroup, 28 November 2010. http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/118050.pdf

¹²¹ European Council 24/25 March 2011 Conclusions, CO EUR 6 CONCL 3, Annex II, 24 and 25 March 2011. <http://register.consilium.europa.eu/doc/srv?!=EN&f=ST%2010%202011%20INIT>

¹²² European Council (2012), ‘Treaty establishing the European Stability Mechanism’, Factsheet, 2 February 2012. http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/127788.pdf

¹²³ European Council 24/25 March 2011 Conclusions (2011), CO EUR 6 CONCL 3, Annex II, 24 and 25 March 2011. <http://register.consilium.europa.eu/doc/srv?!=EN&f=ST%2010%202011%20INIT>

Those sums would give the ESM a strong position to borrow on the bond markets, enabling the ESM Board of Governors to endow the ESM with a lending capacity of €500 billion, a figure that harked back to euro area pledges at the EFSF's creation in May 2010.

The idea of a fully capitalised crisis response institution had been aired at the outset of the crisis, but wasn't ripe politically, the Commission's Benjamin Angel said. 'We could not have convinced member states at that time to go for a capital structure, so we needed the EFSF to convince them that we could do a much better job and build in future a much more effective and more operational instrument,' he said. 'If we had gone straight to this nice and neat structure that the ESM is, I don't think we could have managed to get everybody on board.'

Work on the ESM Treaty proceeded in the spring and summer of 2011, with the Commission in charge of the drafting. The lead role fell to Angel, who had been one of the Commission's point men in shaping the initial crisis response tools. To sketch out the first version of the ESM Treaty, Angel closeted himself in his office for two days to delve into the workings of existing international financial institutions. 'I printed the statutes of all the IFIs [international financial institutions] I could find, read them and their treaties to see what was behind there: how does it work, what kind of elements do we need to put in?' Angel said. 'We needed to start from somewhere.'

The London-based European Bank for Reconstruction and Development, a multilateral development bank, was founded in 1991 and was thus the youngest major international financial institution at the time. It therefore proved to be a relevant template for internal administrative issues such as staffing and accounting, but that was of secondary importance to the governments that would underwrite the ESM.

'Ministers cared about our capital, how much they had to pay into the ESM because they had to generate the funds, and the treaty. They asked: "What are the voting modalities?" The governance?' That's what is important politically,' Regling said. 'There were very intense negotiations about the treaty.'

Both solidity and flexibility were called for. The ESM had to be firmly grounded, yet adaptable enough to deal with a crisis at an indeterminate point in the future. It made little sense to include treaty language that would confine the permanent fund to using only the two policy instruments then available to the EFSF. Jansen, the firewall's

first general counsel, recalls that, at the time, discussions were already underway over adding tools such as direct bank recapitalisation. The firewall's architects were aware others might be needed in future.

'We knew this possibility and other possibilities, so we included in the treaty Article 19, which said that new instruments can be added by a resolution of the Board of Governors, which means the treaty need not be changed,' Jansen said.

One question for the ESM Treaty was what kind of ties the permanent fund would have to the IMF. Even the member states that had sought an IMF role in the euro rescue effort were hesitant to write this irrevocably into the ESM Treaty. Nor could the euro area pre-commit the IMF on any policy question. The solution was to require a euro area member state that solicits financial aid to also 'request' it from the IMF, without prejudging the outcome.

ESM Treaty drafters had to address concerns in the markets – amplified by the growing speculation in early 2011 that Greece would have trouble repaying its debts – that the permanent fund would be used as a debt-restructuring vehicle to force losses on private sector bondholders. Some investors were critical of a treaty requirement that all euro area member states equip their sovereign bonds with collective action clauses, which set out a predictable mechanism to allow a voluntary agreement on a re-profiling or restructuring in crises, thereby preventing bondholders from refusing to take part.

Some countries had instituted similar clauses already. The treaty stipulated that all ESM Members attach collective action clauses in new bond issuances (with maturities above one year) as of 1 January 2013, grandfathering previously issued debt as per standard practice. Vittorio Grilli, a former Italian finance minister and now a senior executive at J.P. Morgan, said that both the clauses and the exemption for existing bonds served to enhance euro area financial stability. 'They were very careful that the collective action clauses would not apply to the outstanding debt,' he said.

The first version of the treaty explicitly gave the ESM a role on debt sustainability management. In cases where debt was deemed sustainable, private investors would be encouraged to maintain their exposure; but, in cases where debt was not deemed to be sustainable, programme countries were required to engage in active negotiations in good faith to secure direct involvement from their non-official creditors in restoring debt sustainability. The first version went as far

as saying that the granting of financial assistance would be contingent on the country having a credible plan for restoring debt sustainability and on its demonstrating sufficient commitment to ensure adequate and proportionate private sector involvement. Progress in the implementation of that plan would be monitored under the programme and would be taken into account in the decisions on disbursements. Given the market jitters around requiring haircuts on sovereign debt, this was missing from the second and final ESM Treaty that would be adopted in 2012, other than a mention in the opening recitals.

Similar sensitivities were in play over asserting an ESM claim to preferred creditor status in the manner of the IMF. Such status was intended to protect the ESM as a lender of last resort, given that it is willing to lend to sovereigns when no one else does, in the case of a debt restructuring. This was not an issue for the EFSF, which ranks on an equal footing with other creditors. For the ESM, it was not clear how markets would manage the transition to the new framework, as other creditors had not been expecting their claims to become lower priority in the euro area. It was eventually decided politically that the firewall should waive preferred creditor status for Spain's aid programme.

With respect to the ESM's preferred creditor status, some nations made the point that taxpayers would benefit from the added protection, since, as a lender of last resort, the ESM would lend to a country only when all other investors are out. The counterargument was that it could scare off the same bond investors that the ESM was meant to put at ease. What is more, while the IMF's status atop the lending hierarchy has been recognised thanks to its global membership, there was concern that investors outside Europe might contest the 'preferred' claim of the ESM as a purely European entity.

'Preferred creditor status is good for you as preferred creditor, but it's not good for the other creditors,' said ESM Risk Officer den Ruijter. 'It was quite a tricky issue and there were strongly divergent views among the countries.'

The solution reached in June 2011 was to rank the permanent fund as a preferred creditor just below the IMF, a status that did not apply to EFSF lending to the three countries then receiving rescue loans¹²⁴. A year later, the same held true for Spain's bank recapitalisation

¹²⁴ Reuters (2011), 'ESM not preferred creditor for three bailout states', 20 June 2011. <https://www.reuters.com/article/eurozone-esm-status/esm-not-preferred-creditor-for-three-bailout-states-idUSLDE75J1OG20110620>

programme, which was transferred to the ESM from the EFSF ‘without gaining seniority status’ in order to reassure holders of Spanish bonds that their investments would not be suddenly demoted in the creditor hierarchy¹²⁵.

Wealth divergence across the euro area led to an adjustment of the national capital contributions. Central European countries such as Slovakia, with GDP per capita below the euro area average, argued that it was too burdensome for them to pay into the ESM at the same rate – based on each country’s shareholding in the ECB – as the more advanced economies.

Den Ruijter, who was at the time with the Dutch finance ministry, worked out a mechanism to benefit new ESM Members with GDP per capita below 75% of the EU average. This adjustment applies to the initial paid-in capital plus any future capital calls or increases in the overall capital stock. It is spelled out in Article 42 of the ESM Treaty, with eligibility restricted to the first 12 years of a country’s euro membership. Slovakia, for example, will benefit until 2020, whereas Lithuania, which joined in 2015, can benefit from the mechanism until the end of 2026. Malta, Estonia, and Latvia, are all also currently benefiting. Slovenia’s temporary adjustment ended on 1 January 2019.

‘The correction is only temporary because we assume that over time they’ll catch up with the rest of the euro area,’ den Ruijter said.

On 11 July 2011, finance ministers from the then 17 euro countries signed the first version of the ESM Treaty¹²⁶, an act that would normally be the prelude to ratification by the Member States. But by then, forces were at work – in Greece, in the euro area more broadly, and in financial markets – that would lead the euro area to redo the treaty, revise its crisis-fighting strategy, and retool its rescue funds.

¹²⁵ Statement by the Eurogroup, 20 July 2012. http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/131914.pdf

¹²⁶ Treaty establishing the European Stability Mechanism, 11 July 2011, Luxembourg. https://www.cvce.eu/en/obj/treaty_establishing_the_european_stability_mechanism_11_july_2011-en-cb18477d-69e4-4645-81a9-3070e02d245a.html

Expanding the EFSF toolkit: bonds, banks, and guarantees

16

Seventeen democracies cannot react as quickly as financial markets, which may change every minute. Political processes need time.

Klaus Regling

ESM Managing Director and EFSF Chief Executive Officer

The 2011 accord to create a permanent mechanism was a breakthrough. Still, the ESM's scheduled start date was more than two years away. The euro area had to take more immediate action to counter the crisis. At an emergency summit on 11 March 2011, beefing up the EFSF and providing more relief for distressed countries dominated the agenda, a peak in the long debate over the euro area's rescue capacity.

From the outset, the EFSF's principal drawback had been its structure of national guarantees. In June 2010, the euro area took an initial step to address the problem that not all the countries providing these guarantees were themselves rated AAA: it raised its backing to 120% of the fund's capacity. But, even with that buffer, the EFSF could garner a top rating only if it limited its total possible lending envelope to about €250 billion, well below the €440 billion proclaimed in May 2010.

Faced with the inescapable mathematics, the leaders had no choice but to bolster the guarantees a second time. So, at the March 2011 summit, they pledged to make the targeted EFSF lending capacity 'fully

effective¹²⁷ until the ESM took over. In practice, that entailed raising the EFSF guarantees to €780 billion, or 165% of the total, in order to underwrite lending of the full €440 billion. By October 2011 the whole amount was available, minus the funds that by then had been set aside for Ireland and Portugal.

In the virtuous circle of winning market confidence for the euro rescue effort, the 2011 guarantee increase was pivotal. Stronger euro area backing for the rescue fund translated into more market confidence, which in turn allowed the EFSF to borrow under more favourable conditions. Better access to market financing lessened the likelihood of the guarantees ever having to be activated.

Programme countries were the ultimate beneficiaries. Secure access to funding swept aside any doubts about the EFSF's ability to put together aid packages.

Ultimately, no money would change hands to lift the guarantee levels. Moreover, as long as the programme countries followed through on their economic and budget commitments, the risk that the guarantees would need to be called was low.

For accounting purposes, however, the EU statistical authority, Eurostat, classified the use of the guarantees as debt. As long as the EFSF remained unused, this point was moot. However, as soon as the EFSF started to issue debt to fund programmes, each such issue also upped EFSF shareholders' debt figures in line with their share of the guarantee given¹²⁸.

'If you look at the EFSF and certain aspects of the EFSF, at how debts of the EFSF were routed to Member States, that is one aspect that perhaps could have been addressed better,' Malta's Camilleri said. 'But, within the context in which we were operating, here was a list of priorities which had to be taken first. Which was the biggest priority? The biggest priority was stabilisation.'

The euro area had already acted to minimise the deleterious statistical impact on aid recipients: in designing the technical specifications for the start-up EFSF, they had added in 2010 a 'stepping-out mechanism' that released countries that were receiving aid from the financial responsibility of standing behind the rescue mechanism as a whole. New euro members such as Estonia, Latvia, and Lithuania were also exempt from providing guarantees that predated their full euro membership. Still, the guarantee

¹²⁷ Conclusions of the Heads of State or Government of the euro area of 11 March 2011, 11 March 2011. <https://www.consilium.europa.eu/media/21423/20110311-conclusions-of-the-heads-of-state-or-government-of-the-euro-area-of-11-march-2011-en.pdf>

¹²⁸ Eurostat (2011), 'New decision of Eurostat on deficit and debt. The statistical recording of operations undertaken by the European Financial Stability Facility', Press release, 27 January 2011. <https://ec.europa.eu/eurostat/documents/2995521/5034386/2-27012011-AP-EN.PDF>

difficulties showed the EFSF's limitations and the need for the ESM to take its place as the euro area's backstop.

In March 2011, however, the EFSF was all that was available. At the emergency summit, leaders also took the first in a series of steps to expand the rescue toolkit, by empowering the EFSF to purchase bonds on primary markets¹²⁹. This tool, which went through several permutations as the rescue funds evolved, was intended to shore up borrowing by countries with partial market access. Buoyed by the EFSF as an additional buyer, bond sales would be less likely to be stymied by insufficient demand. This instrument has not been used, but remains available through the ESM should a country ask for it.

May 2011 brought fresh urgency. On 6 May 2011, finance ministers from Germany, Spain, France, and Italy met with Trichet, then president of the ECB, at a castle in Luxembourg to discuss more aid for Greece and the real prospect of writing down Greek debt and forcing losses on private investors. Trichet was distressed at the time by leaks to the media about a meeting out of the public eye and the presumption that the agenda included Greece's potential departure from the euro area – particularly since the Deauville deal was still on the table. Trichet, an adamant opponent of normalising sovereign debt writedowns, walked out of the meeting. Nonetheless, the event prompted press reports that Greece might leave the euro.

The international crisis-fighting team was thrown into further turmoil when IMF Managing Director Strauss-Kahn stepped down that same month¹³⁰. In early July, France's Lagarde was named his successor, around the same time that Italy's Draghi was chosen to take over from Trichet at the ECB.

Meanwhile, market access was faltering in many corners of the euro area. In mid-May, the EU published debt and deficit forecasts that showed further erosion of the fiscal outlook in Greece and Portugal. On 31 May, Cyprus drew a three-notch downgrade from Fitch, and other markdowns followed. On 5 July, Moody's cut Portugal's long-term sovereign debt to below investment grade status¹³¹.

¹²⁹ Conclusions of the Heads of State or Government of the euro area of 11 March 2011, 11 March 2011. <http://www.consilium.europa.eu/media/21423/20110311-conclusions-of-the-heads-of-state-or-government-of-the-euro-area-of-11-march-2011-en.pdf>

¹³⁰ IMF (2011), 'IMF Managing Director Dominique Strauss-Kahn resigns', Press release, 18 May 2011. <http://www.imf.org/en/News/Articles/2015/09/14/01/49/pr11187>; *Financial Times* (2011), 'Strauss-Kahn resigns as head of IMF', 19 May 2011. <https://www.ft.com/content/ab0bdf0a-81ce-11e0-8a54-00144feabdc0>

¹³¹ For further discussion of the factors that influence sovereign ratings, see D'Agostino, A. and Lennkh, R.A. (2016), *Euro area sovereign ratings: An analysis of fundamental criteria and subjective judgement*, ESM Working Papers 14, 12 May 2016. <https://www.esm.europa.eu/publications/euro-area-sovereign-ratings-analysis-fundamental-criteria-and-subjective-judgement>

Sobering fiscal numbers, deteriorating credit quality, and waning confidence in Greece's turnaround combined to unnerve financial markets. It was clear that part of the original strategy – elevated interest rates on official loans to deter other would-be borrowers – was not having the intended effect.

Euro area leaders rebooted the crisis-fighting strategy at another hastily arranged summit, in July 2011. Relief for programme countries, in the form of lower rates and longer loans, was accompanied by a decision to further expand the rescue toolkit. The EFSF and, later, the ESM were equipped with three new instruments: secondary-market bond buying, precautionary aid programmes, and indirect bank recapitalisation in order to help countries reinforce their financial sectors without a full-scale macroeconomic adjustment programme.

The secondary market purchases, which so far have never been used, would take advantage of the firewall's influence in the market in a completely different way from its usual activities. For the ESM's day-to-day investment operations, the opposite effect is required: the objective is to buy and sell sovereign bonds and other securities without a noticeable impact on market pricing. But if the euro area were to authorise sovereign bond purchases – possibly alongside a precautionary or full economic adjustment programme – the ESM would design its purchases specifically to support market prices for bonds of the programme country, provided all necessary conditions were met.

Rescue fund purchases of bonds on the secondary market could take place only 'on the basis of an ECB analysis recognising the existence of exceptional financial market circumstances and risks to financial stability'¹³², and only by mutual agreement of all the euro area member states, the summit statement said. Precautionary programmes were designed to support a country's market access and thereby pre-empt a larger crisis by allowing a country to seek help at an early stage and benefit from less strict conditions.

Some of the inspiration for the new firewall tools came from the IMF. Lagarde said the IMF has had positive experiences with countries that took up its precautionary credit lines, and such instruments 'can be extremely helpful.' Just as no country has sought a bond-buying programme, the ESM has yet to use the precautionary instrument. 'There are countries that would do well with a precautionary line, but they are a bit concerned about being associated with it,' she said.

¹³² Statement by the Heads of State or Government of the euro area and EU institutions, 21 July 2011. <https://www.consilium.europa.eu/media/21426/20110721-statement-by-the-heads-of-state-or-government-of-the-euro-area-and-eu-institutions-en.pdf>

One euro area resource, however, is without an IMF equivalent: the banks-only programme that provides loans for countries to recapitalise banks without requiring a full macroeconomic programme. It is known as indirect bank aid because the funds are channelled through the national government. It has been used successfully in Spain, where it was granted under the EFSF and then transferred to the ESM by the time funds were disbursed. Later on, once the ESM was in place and the EFSF had ceased offering new programmes, the euro area would consider whether or not to provide direct bank aid and remove the national government from the financial equation, but back in 2011 there was no such instrument.

The summit deal was essential to secure central bank support for the by now inevitable impending writedown of Greece's privately held debt. Trichet had been pushing back against the idea because he didn't want the euro area to set a precedent that could spook markets, but the July talks persuaded him to adjust his stance.

The former ECB chief said he thought it would at some point be necessary to engage in debt alleviation for Greece. However, as long as the Deauville agreement was in the air, any such event would be interpreted by market participants as the first in a sequence that could touch all vulnerable countries in the euro area, risking its dismantling. It needed to be clear that taking action regarding Greece would not lead to similar fates for other euro countries. Trichet said this reasoning led him to assent, on behalf of the ECB, in July 2011 to debt writedowns for Greece, as long as the euro area agreed to certain conditions.

Specifically, he wanted assurances that the ECB would not be hurt by the event; that the governments would affirm solemnly that all other countries would honour their obligations, in effect cancelling the Deauville agreement; and that the governments accepted that they could intervene themselves on the secondary market of public debts. The goal was ring-fencing all other euro countries from Greece-related contagion. When the EU leaders released their July 2011 statement, the key paragraph for Trichet was this: 'As far as our general approach to private sector involvement in the euro area is concerned, we would like to make it clear that Greece requires an exceptional and unique solution'¹³³.

Trichet said the euro area also benefited from its July commitment to bolster the EFSF and ESM with new tools, particularly by giving the firewalls the power to intervene on secondary bond markets under exceptional circumstances. This was an 'extremely important decision' that gave the euro area more tools to address contagion, he said.

¹³³ Ibid.

Focus

Bond-buying power

Early in the EFSF's existence, the euro area decided it should have the power to buy bonds on primary or secondary markets, if requested by a euro area member state in danger of losing market access. These tools could be used to help the country raise liquidity and support the demand for its bonds. Any such programme would first need to be requested by the beneficiary and approved by the Eurogroup, along with the necessary conditions. But then it would need to be executed.

Primary-market purchases would be carried out by the EFSF's funding team, with its substantial experience in bond offerings. Secondary-market purchases might be trickier, especially in the EFSF's early days, when there was not yet an established investment department.

The Bank of France and the ECB decided to help. The EFSF developed a governance system and communications platform for collaborating with the two central banks. 'Very quickly the capacity of the EFSF was put in place. Everything was ready at a very early stage – but it's never been used,' said Sébastien Lévy, a former Bank of France staffer who is now the ESM's head of investment and treasury.

The ESM now has two bond-buying instruments at its disposal that countries may request: primary-market purchases, intended to help countries continue to sell bonds directly to investors, and secondary-market purchases, which can be used to aid liquidity on capital markets.

With the ESM's establishment, the ECB withdrew and focused on its own bond-buying programmes. The ESM took over all EFSF activities. But the Bank of France has remained on call as a service provider for both the EFSF and now the ESM. Should a secondary-market purchasing programme ever take place, the ESM's investment division would be at the helm of the operation, but trades could be carried out in either Luxembourg or Paris. This gives the ESM more flexibility, and also more avenues for carrying out its purchases.

In August 2011, Spain and Italy became the targets of market speculators, amid warnings from private sector analysts that their market access was under threat¹³⁴. Trichet said he turned to the July

¹³⁴ *New York Times* (2011), 'Worries rise over Spain and Italy debt', 2 August 2011. <https://www.nytimes.com/2011/08/03/business/global/pressure-builds-on-italy-and-spain-over-finances.html>

framework as the basis for a series of actions to push back against the financial contagion. First, he asked the euro area governments – particularly Germany and France – to confirm their July commitments. He also wrote on behalf of the ECB to the prime ministers of Spain and Italy, ‘to draw their attention to the necessity of regaining creditworthiness through effective and visible measures’. Against this backdrop, the ECB was ready to act.

The ECB sought to protect its monetary transmission mechanism, by patching up dysfunctional segments of bond markets. On 4 August, the ECB voted to resume its own bond-buying programme, which it had started in 2010 during the euro area’s first efforts to build a coordinated crisis response¹³⁵. Three days later, the ECB held an emergency conference call and signalled it would begin purchasing Italian and Spanish bonds as part of its Securities Markets Programme¹³⁶. The impact was immediate: the next day, Spain’s 10-year yield fell 88 basis points to 5.16% and Italy’s sank 80 basis points to 5.28% on Monday 8 August.

But that respite proved short-lived. There was a perception that contagion was beginning to spread. In the month of October alone, Spain and Italy were hit by a wave of downgrades attributed to political uncertainty, weak growth, and the ongoing crisis. Standard & Poor’s downgraded Cyprus and Slovenia.

¹³⁵ ECB (2011), ‘Introductory statement to the press conference (with Q&A)’, Transcript, 4 August 2011. <https://www.ecb.europa.eu/press/pressconf/2011/html/is110804.en.html>

¹³⁶ ECB (2011), ‘Statement by the president of the ECB’, Press release, 7 August 2011. <http://www.ecb.europa.eu/press/pr/date/2011/html/pr110807.en.html>

New EFSF instruments

June 2010, EFSF commences operations

Initial design includes powers to offer macroeconomic assistance programmes to governments that accept conditions.

March 2011, political agreement¹³⁷ on:

- extra guarantees to make the full €440 billion capacity available for programme lending;
- reduction in interest rates for countries that accept reform programmes;
- possibility of primary-market bond purchases.

July 2011, political agreement¹³⁸ on:

- precautionary aid programmes;
- indirect bank recapitalisation;
- possibility of secondary-market bond purchases.

October 2011, political agreement¹³⁹ on:

Possibility of leverage to expand capacity of funds, fleshed out by finance ministers and leaders in November and December.

February 2012, leverage programmes ready for use if needed

Two versions:

1. European Sovereign Bond Protection Facility (ESBPF), which would provide partial-risk protection certificates to new bonds issued by programme countries. Primarily designed to work as part of a precautionary aid programme; would back 20% to 30% of bond value.
2. European Sovereign Bond Investment Facility (ESBIF), a co-investment fund, which would use funds from public and private investors to purchase bonds in the primary and secondary markets, with a first loss tranche to be financed by EFSF.

June 2013, EFSF phased out

Leverage vehicles remain unused.

3 December 2015

ESBPF liquidated and closed.

7 December 2016

ESBIF liquidated and closed.

¹³⁷ Conclusions of the Heads of State or Government of the euro area of 11 March 2011, 11 March 2011. <http://www.consilium.europa.eu/media/21423/20110311-conclusions-of-the-heads-of-state-or-government-of-the-euro-area-of-11-march-2011-en.pdf>

¹³⁸ Statement by the Heads of State or Government of the euro area and EU institutions, p. 3, 21 July 2011. <https://www.consilium.europa.eu/media/21426/20110721-statement-by-the-heads-of-state-or-government-of-the-euro-area-and-eu-institutions-en.pdf>

¹³⁹ Euro summit statement, p. 6, 26 October 2011. https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/125644.pdf; Statement by the euro area Heads of State or Government, p. 5, 9 December 2011. https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/126658.pdf

Meeting at the opera: the leverage debate

17

*Intergovernmentalism was the solution
to the crisis.*

Thomas Wieser

Chairman of the Eurogroup Working Group
(October 2011–January 2018)

Euro area politicians were under fire in their own countries as the crisis gained speed, which made it hard to find common ground on how next to tackle the crisis. On the one hand, the ESM was on the way and the EFSF was fully operational. On the other, each additional step towards a comprehensive firefighting approach, however incremental, was met with fierce debate.

Leaders met for a record 11 times in 2011 alone, debating how – and how far – to extend the rescue funds' financial reach. Over the course of five formal meetings, an extraordinary summit, and one 'informal' meeting of the European Council, four euro area summits, they debated new tools for the EFSF and how to ensure the permanent firewall's decision-making agility. The process would culminate in a dramatic move to make the ESM more responsive and bring forward its start date. But first they had to prepare the political ground.

Top of the agenda was the guarantee increase to unlock the EFSF's full capacity. Germany's Constitutional Court cleared the way on 7 September 2011, dismissing legal challenges to the temporary

firewall and residual objections to the first Greek programme. The court also held that, in general, a German role in major rescue operations required the approval of either the Bundestag's budget committee or a full plenary session.

The next step was persuading German lawmakers to grant their consent to the EFSF expansion. Regling, the EFSF's chief executive, contributed to the debate by testifying before the German parliament.

'It was probably useful that I was there to explain it in person,' said Regling. A German newspaper that was sceptical of the changes 'wrote at one point that if I had not been there, maybe it wouldn't have gone through parliament or the hostility would have got out of control.' Despite the endorsement by the euro area's largest country, politics elsewhere was marked by growing resistance to the rescue programmes.

Finland added a condition to its involvement in future rescues, after the eurosceptic True Finns party surged to 19% of the vote in parliamentary elections¹⁴⁰. The new government coalition insisted on obtaining collateral from aid recipients before assenting to a programme. For aid-seeking countries, putting up collateral would entail an additional cost – one that would potentially undercut a rescue package in the event that more creditor countries followed Finland's example.

In Slovakia, the EFSF upgrade led to the downfall of Prime Minister Radičová's government. While three coalition partners favoured the guarantee increase as the necessary price for euro membership, a junior partner, the Freedom and Solidarity Party, baulked. On 10 October, the EU urged Slovak political parties 'to rise above the positioning of short-term politics'¹⁴¹, but Radičová lost a confidence motion a day later. In the political bargaining that ensued, the opposition party Smer agreed to back the EFSF enhancements in exchange for the holding of early elections in 2012. The EFSF bill passed on 13 October. Radičová's government went on to be defeated in the subsequent election.

¹⁴⁰ Statistics Finland (2011), 'True Finns the biggest winner in the elections. Coalition party the largest party in the parliamentary elections 2011', 29 April 2011.
https://www.stat.fi/til/evaa/2011/evaa_2011_2011-04-29_tie_001_en.html

¹⁴¹ Joint statement by President Herman Van Rompuy and President José Manuel Barroso on the recent political developments in Slovakia (2011), EUCO 95/11, 12 October 2011.
https://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/125058.pdf

With a Group of 20 summit looming in November, pressure on Europe to do more mounted from every direction. The Vix index, for instance, which measures future volatility and global risk aversion, had been elevated since August. EU countries outside the euro suffered from growing market volatility, yet had no control over euro area policy and would face the consequences of inaction or heightened crisis. Countries outside the EU were affected too.

The world was watching what tack the euro area would take; the IMF's Lipton said: 'It needed to be convincing enough to calm markets and avoid contagious spread of sovereign risk premia that seemed to be such a threat to other governments.'

There was no shortage of ideas for getting more firepower out of the euro area's rescue funds. France proposed granting the EFSF a banking licence, enabling it to borrow from the ECB. But others argued that a bank-style credit line for the EFSF would intrude on the central bank's independence and violate rules against the monetary financing of governments.

Crisis diplomacy went into overdrive in October, ranging from the traditional summit venue in Brussels to backroom discussions among key leaders at Frankfurt's Old Opera House during a retirement ceremony for Trichet at the end of his ECB term. Trichet used the occasion to remind the euro area leaders in attendance of the commitments they had made at the 21 July summit¹⁴².

Euro summits on 23¹⁴³ and 26 October¹⁴⁴ addressed what European Council President Van Rompuy called 'the by now familiar fronts where action was needed: Greek debt sustainability, the firewall against contagion, the banking sector, economic growth'¹⁴⁵.

To give the EFSF more heft, the leaders decided to set up two leverage vehicles that could use smaller upfront investments to unlock far larger aid sums. Eventually these would be christened the European

¹⁴² Statement by the Heads of State or Government of the euro area and EU institutions, 21 July 2011. <https://www.consilium.europa.eu/media/21426/20110721-statement-by-the-heads-of-state-or-government-of-the-euro-area-and-eu-institutions-en.pdf>

¹⁴³ European Council, 23 October 2011, Conclusions, EUCO 52/1/11, 30 November 2011. https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/125496.pdf

¹⁴⁴ Euro summit statement, 26 October 2011. https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/125644.pdf

¹⁴⁵ *The European Council in 2011*, p. 7, January 2012. <https://www.consilium.europa.eu/media/21347/qcao11001enc.pdf>

Sovereign Bond Protection Facility and the European Sovereign Bond Investment Facility, the latter a co-investment fund able to draw investors from around the world.

‘The leverage effect of both options will vary, depending on their specific features and market conditions, but could be up to 4 or 5,’ euro leaders said in the 26 October 2011 statement¹⁴⁶.

Each would require incorporating a new special purpose vehicle in Luxembourg under plans drawn up quickly by the EFSF staff. On Sunday 30 October, the EFSF’s leadership convened in a global teleconference. Regling and CFO Frankel were in Tokyo, while the EFSF’s investment advisors were in New York. Jansen, then general counsel, was spending the day with his family, while Anev Janse, the secretary general, was celebrating his 29th birthday. The party didn’t quite turn out as planned.

‘On that particular Sunday, all of a sudden we had to have a Management Board meeting,’ Anev Janse said. ‘Next to the EFSF and ESM, we had to create two other separate entities. From noon until five in the afternoon, I was on a call discussing questions like: “How do we set up these SPVs [special purpose vehicles]? How do we make this work organisationally? What are the financial structures? How do we build that into our systems?”’

As details came into focus, it became evident that the proposed up to five-fold leveraging of EFSF funds was a bridge too far. Part of the existing facility was already allocated to Ireland and Portugal, with more earmarked for Greece. In addition, it appeared that financial markets would require more participation from the EFSF to make either of the leverage plans workable. Doubling or tripling resources from the fund would be more realistic, under proposals Regling brought to a November meeting of the Eurogroup.

Both leverage options could be combined with other rescue instruments, but unlike other EFSF tools, they wouldn’t be taken over by the ESM. At their debut, however, they were an anchor point for the euro area strategy. The next summit, on 9 December 2011, vowed that

¹⁴⁶ Main results of euro summit, 26 October 2011.
http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/125645.pdf



(From left) Evangelos Venizelos, Greece's finance minister, Olli Rehn, the European Union's economic and monetary affairs commissioner, Wolfgang Schäuble, Germany's finance minister, Jean-Claude Juncker, Luxembourg's prime minister and president of the Eurogroup, and Mario Monti, Italy's prime minister, arrive for a Eurogroup finance ministers meeting at the European Council headquarters in Brussels, Belgium, on 29 November 2011 as efforts to expand the rescue fund falter.

Credit: Jock Fistick/
Bloomberg via Getty Images

they would be 'rapidly deployed'¹⁴⁷, and the two vehicles were declared ready for use in February 2012¹⁴⁸. But the leverage vehicles would later be dissolved, unused, even though investors had expressed interest in cooperating on their financing.

By the following year, the crisis – and the response – would move on, as centre stage shifted to more overarching decisions on economic governance and crisis management also taken at that same 9 December summit. These actions, as so often in policymaking to stabilise the euro area, reflected a compromise between the interests of creditor and programme countries by acting on two fronts, crisis prevention and crisis response.

On the governance front, the leaders toughened the euro area's fiscal rules by committing to a new pact – eventually known as the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union¹⁴⁹ – that enshrined the pursuit of balanced budgets

¹⁴⁷ Statement by the euro area Heads of State or Government, 9 December 2011.

<http://ec.europa.eu/dorie/fileDownload.do?sessionId=zrKxL3Cyx2bUHVaut8198iEXakiK35PBFqXWiHCu9k50-L7EIBv!1583997504?docId=1099413&cardId=1099411>

¹⁴⁸ EFSF (2012), 'European sovereign bond protection facility launched', Press release, 17 February 2012. <https://www.esm.europa.eu/press-releases/european-sovereign-bond-protection-facility-launched>

¹⁴⁹ Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, 2 March 2012. https://www.consilium.europa.eu/media/20399/st00tscg26_en12.pdf

in national law and committed euro countries to closer economic coordination. While open to countries outside the euro area, the fiscal compact¹⁵⁰ was binding on the common currency countries and the additional EU countries that opted in. Twenty-five of the then 27 EU countries signed it in March 2012¹⁵¹.

As Regling explained, the push for more effective rules meant that ‘national governments will remain in charge and accountable, responsible for their fiscal and structural reforms. However, reforms need to be better coordinated and must work better than in the past.’

The commitment to enhanced fiscal stewardship, to be made at the constitutional level in most cases¹⁵², was intended to help countries avoid the need for a rescue programme. The pledges also paved the way for a breakthrough on crisis management tools.

Moving beyond earlier steps to increase the EFSF’s firepower, the leaders announced at the summit that the launch of the ESM – then scheduled for mid-2013 – would be brought forward by a year, to July 2012.

‘The Treaty will enter into force as soon as Member States representing 90% of the capital commitments have ratified it,’ the post-summit statement said¹⁵³. ‘Our common objective is for the ESM to enter into force in July 2012.’

The planned speedier introduction of the ESM reshaped the course of crisis management. Although that timetable would slip by a few months, the move was still a decisive step forward that unshackled the rescue effort from the EFSF’s guarantee structure. Equally important to getting the ESM up and running fast, the euro area sped up the delivery of the ESM’s paid-in capital, starting with two tranches in

¹⁵⁰ ECB (2012), ‘Main elements of the fiscal compact’, *Monthly Bulletin*, p. 101, March 2012.
https://www.ecb.europa.eu/pub/pdf/other/mb201203_focus12.en.pdf?0ea5f8ccbeb103061ba3c778

¹⁵¹ European Commission (2017), ‘The fiscal compact – taking stock’, 22 February 2017.
https://ec.europa.eu/info/publications/fiscal-compact-taking-stock_en

¹⁵² European Commission (2017), ‘Report from the Commission presented under Article 8 of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union’, C(2017) 1201 final, Appendix III, pp.18-19, 22 February 2017.
https://ec.europa.eu/info/sites/info/files/c20171201_en.pdf

¹⁵³ Statement by the euro area Heads of State or Government, 9 December 2011.
<http://ec.europa.eu/dorie/fileDownload.do?sessionId=zrKxL3CyxC2bUHVaut8198iEXakiK35PBFqXWiHCu9k50-L7EiBv!1583997504?docId=1099413&cardId=1099411>

2012 and concluding with the final tranche in 2014, a full four years ahead of the original schedule¹⁵⁴.

Critical features of the proposed ESM were modified as well. Amid lingering concerns in the markets that Greek bond writedowns, by then under negotiation, would set a precedent for future rescues, the leaders added language to the preamble of the ESM Treaty to reassure investors that the Greek solution was ‘unique and exceptional’¹⁵⁵. Only in extreme cases, the summit statement said, would the ESM pursue private sector involvement, and then solely in accordance with ‘well established IMF principles and practices.’

Summit debate then tackled the requirement for unanimous decisions on loans to programme countries – a rule written into the first draft of the ESM Treaty. There was widespread recognition that, given the vagaries of national politics, the unanimity rule could hinder rescue efforts, especially when rapid intervention was called for. At the summit, the leaders added an emergency procedure to the ESM Treaty that would allow the granting of financial assistance over the objections of some of the euro area’s smaller members.

‘To ensure that the ESM is in a position to take the necessary decisions in all circumstances, voting rules in the ESM will be changed to include an emergency procedure. The mutual agreement rule will be replaced by a qualified majority of 85%, in case the Commission and the ECB conclude that an urgent decision related to financial assistance is needed when the financial and economic sustainability of the euro area is threatened,’ the leaders said¹⁵⁶.

Under the 85% threshold, Germany, France, and Italy, the ESM’s three largest shareholders, continued to have blocking powers. As Schäuble, then German finance minister, explained, this was essential for him to support the ESM.

‘Given the sums involved, someone has to take responsibility for them – namely the taxpayers in the member states, including the Germans

¹⁵⁴ Statement of the Eurogroup, 30 March 2012.

https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/129381.pdf

¹⁵⁵ Statement by the euro area Heads of State or Government, 9 December 2011.

<http://ec.europa.eu/dorie/fileDownload.do?sessionId=zrKxL3Cyx2bUHVaut8198:EXakik35PBFqXWiHCu9k50-L7EIBv!1583997504?docId=1099413&cardId=1099411>

¹⁵⁶ Treaty establishing the European Stability Mechanism, 11 July 2011.

https://www.cvce.eu/en/obj/treaty_establishing_the_european_stability_mechanism_11_july_2011-en-cb18477d-69e4-4645-81a9-3070e02d245a.html

with their 27% share in the paid-in capital,' Schäuble said. 'Parliament is accountable to the German taxpayers, and the finance minister is in turn accountable to parliament. Nobody can relieve me of this responsibility.'

Teixeira dos Santos, then Portuguese finance minister, said the shift to the 85% rule overcame 'a serious limitation on the decision-making process – without which member states in crisis could see the approval of the rescue programme refused or delayed. That would further worsen the situation.'

Recalling the negotiations in the Task Force on Coordinated Action, Benjamin Angel of the European Commission said it took 'several attempts' to remove the unanimity rule. 'It's potentially good to have these procedures, even though we haven't used them,' he said.

Taken together, the ESM overhaul reflected lessons learned from two years of crisis fighting and gave the euro area a new toolbox for curbing contagion. Nevertheless, the new clause notwithstanding, it would still be hard for the euro area to press ahead with major decisions without consensus.

'Just think of how difficult it was for certain smaller ESM Members to justify the Greek programme to their own populations,' said Schäuble. 'If all Members support a programme, then at least one important precondition is met in terms of achieving political acceptance in the monetary union.'

Rethinking rescue funding: the diversified strategy

18

As a permanent issuer in the market, you need to have a strategy that can be communicated. Transparency and reliability are key.

Thomas Weinberg

Head of the German Finance Agency's EFSF team (2010–2013)

With outstanding rescue debt reaching out a couple of decades, it became obvious over the course of 2011 that the newly operational EFSF and the incipient ESM were already in the market for the long haul. This required the EFSF to step back and craft a plan for how to go about this in the fixed-income markets. The resulting diversified funding strategy, in place by November 2011, proved to be one of the firewall's most pivotal strategic moves¹⁵⁷.

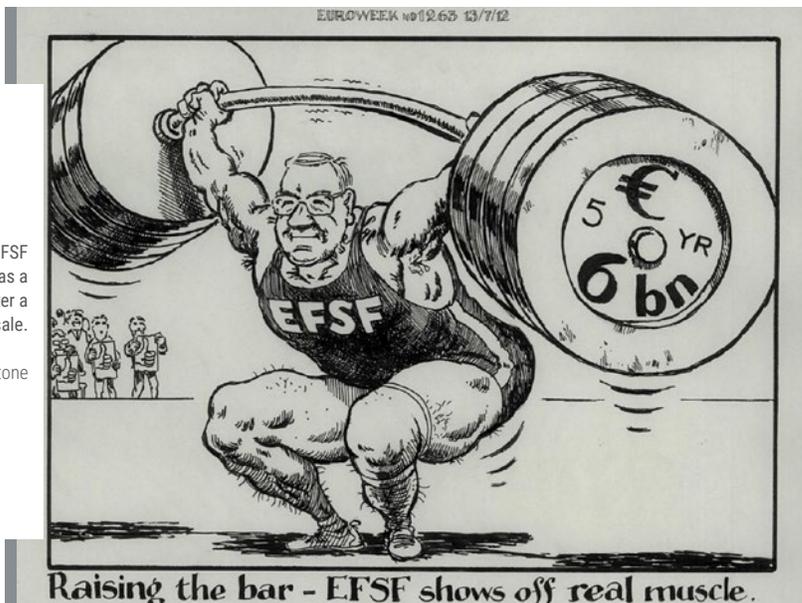
'Looking back, this was the crucial element to make it possible for the EFSF and ESM to be such a success,' said Ruhl, head of funding and investor relations. 'With the liquidity needs for Portugal and Greece, back-to-back funding wouldn't have allowed us to raise the money needed. We needed to broaden our approach.'

¹⁵⁷ EFSF (2012), 'Financial statements, management report and auditor's report: 31 December 2011', p. 3, 12 June 2012. <https://www.esm.europa.eu/sites/default/files/efsannualaccounts2011.pdf>

As the debt crisis deepened, the EFSF faced increased uncertainty with its initial market approach of borrowing only when ready to disburse. Programme country negotiations missed deadlines, and political discussions frequently ended without a verdict. Because the EFSF couldn't raise money until a programme disbursement was approved, it couldn't front-run its future borrowing needs even when it looked like another rescue was on the immediate horizon.

'For every single country, the time between the request and the disbursement was short, which meant we had to rush to be able to help them immediately after the request,' said CFO Frankel. 'If you cannot prepare, it is obvious that you don't get the best price.'

As more countries required emergency assistance, talks began on the best way to facilitate ongoing market access. The firewall's initial back-to-back funding strategy called for a straightforward approach to financial markets: one bond, one loan, with similar maturities, rates, and financial characteristics, issued by the EFSF for the programme country. But, as the EFSF was increasingly pressed into service, inefficiencies emerged. Borrowers wanted relatively long loans, but investor appetite was often for much shorter-term securities.



A cartoon depicts EFSF CEO Klaus Regling as a prize weightlifter after a 2012 bond sale.

Credit: Olly Copplestone

Pooled funding was the first revolution. Instead of borrowing at the last minute before a disbursement was due, the EFSF began tapping the market strategically, then holding on to the money until all conditions for a payout were met.

The EFSF formally switched to selling its first pooled bill under the diversified funding strategy in early 2012. That framework evolved into a strategy, in which the ESM raises funds into a long-term pool of capital market instruments and a short-term pool of money market instruments. These two pools fund the disbursements and maintain a liquidity buffer.

To set up the diversified funding strategy, the firewall would need to build an in-house treasury to manage the liquidity pool between receiving the funding and disbursing it.

The EFSF had been drawn up to be as temporary as possible to prevent countries from overusing it, making the proposition a hard sell for some. ‘This was a tough negotiation with the Members,’ said Funding Officer Rodriguez. ‘But we were able to convince them that it was crucial to obtain the best possible funding conditions from the markets, which would ultimately reduce the lending rates for the countries receiving the financial assistance.’

The diversified funding strategy took effect just under a year before the ESM was established. When the new fund began to seek investors, they needed to approve the ESM as an institutional name just to set up a credit line that could be tapped once the new fund started to borrow, said Fouqueray-Carrick, who deals with the firewall’s investor relations. Fortunately, the rescue funds’ financing needs meant that the ESM did not need to issue a bond until 8 October 2013¹⁵⁸, precisely one year to the day the ESM opened its doors, giving the team ‘the comfort of a whole year to introduce the institution to investors,’ she said.

During this 12-month period, the ESM nonetheless provided financing for both the Spanish and Cypriot programmes. For Spain, the ESM supplied floating rate notes for the banking sector recapitalisation, circumventing the need to raise funds immediately on the debt capital markets.

¹⁵⁸ ESM (2013), ‘ESM issues inaugural long-term bond,’ Press release, 8 October 2013. <https://www.esm.europa.eu/press-releases/esm-issues-inaugural-long-term-bond>

~ For more on this funding approach, see [‘Focus – When bonds are better than cash’](#)

And, because the ESM also launched a bill programme in January 2013, it was able to finance the first maturing floating rate notes as well as the initial disbursements for the Cyprus programme.

The ESM had considerable advantages over the EFSF, which at this point had already got off to a good start by issuing liquid bonds with big outstanding amounts at several points on the yield curve. A better credit rating and the strength of the paid-in capital behind it made the permanent mechanism an easier sell to investors, Fouquieray-Carrick said. But the team needed to make sure the ESM’s debut went smoothly without undercutting its sibling – which still needs to borrow billions of euros per year while its loans are outstanding. ‘This is still a challenge,’ Frankel said. ‘We don’t want investors to stop buying one and concentrate only on the other.’

The ESM also adopted the diversified funding strategy, which opened the door to other innovations. Regular bill sales, for example, would be one of the ESM’s boldest moves, and a sure sign that the institution intended to be a permanent fixture on global debt markets.

The ESM, aided by the German Finance Agency, chose an auction system for its short-term bills. The ESM auctions were innovative for supranational institutions but typical for government issuers. This approach increased the ESM’s market nimbleness.

‘Auctions are far less labour-intensive and time-consuming than setting up a syndication,’ said Weinberg, who ran the EFSF team when it was based at the German Finance Agency. An auction can be put together within a relatively short time period, and the ESM outsourced the mechanics to the Bundesbank. Weinberg said the move also underlined the ESM’s permanence because a schedule of regular auctions ‘is only used if you’re in the market forever, so to speak.’

This long-term perspective differentiates Europe’s firewalls from the IMF, which finances its programmes from Member States’ foreign exchange reserves rather than raising funds directly from markets. The IMF typically offers relatively short-duration funding

to the countries it helps¹⁵⁹, while the ESM is specifically designed to give countries long-term access to affordable funding. The firewall harnesses the power of short-term, high-quality borrowing to make long-term loans to countries that can't manage that kind of market access on their own.

'It is more plausible that the ESM would engage in much longer maturity transformation than would be wise for the IMF,' said Lipsky, former IMF deputy managing director. 'I don't think the idea of 20-, 40-, or 50-year debt from the IMF is in any way a workable model, but it is a possible choice for the ESM.'

The IMF's workhorse tool, the stand-by arrangement, provides for a repayment period of 3.25 to five years, while repayment periods for its longest-term tool, the extended fund facility, run from 4.5 to 10 years¹⁶⁰.

When the ESM took on the Greek programme in 2015, it had reason to issue much longer maturities and therefore access investors with a preference for much longer-dated bonds. With an eye to lengthening its maturity profile, the ESM issued its first 30-year bond on 13 October 2015, raising €3 billion¹⁶¹. It followed up with its first 40-year bond on 24 November to close out its funding programme for the year¹⁶², which was also the first ultra-long euro benchmark bond issued in the sovereign, supranational, and agency issuer world.

¹⁵⁹ IMF (2018), 'IMF lending', 8 March 2018. <https://www.imf.org/en/About/Factsheets/IMF-Lending>

¹⁶⁰ IMF (2018), 'IMF extended fund facility (EFF)', 20 April 2018. <https://www.imf.org/en/About/Factsheets/Sheets/2016/08/01/20/56/Extended-Fund-Facility>

¹⁶¹ ESM (2015), 'ESM issues 30-year €3 billion bond', Press release, 13 October 2015. <https://www.esm.europa.eu/press-releases/esm-issues-30-year-%E2%82%AC3-billion-bond>

¹⁶² ESM (2015), 'ESM issues 40-year €1 billion bond', Press release, 24 November 2015. <https://www.esm.europa.eu/press-releases/esm-issues-40-year-%E2%82%AC1-billion-bond>

Focus

Transparent, flexible funding

Bills: the ESM offers a regular bill programme, auctioning 3- and 6-month paper on the first and third Tuesday of each month. The dates are provided in advance on a quarterly basis, and demand was strong the last couple of years, outpacing supply three to four times. The ESM has been selling bills since its inception, taking over from the EFSF bill-issuance programme.

Bonds: ESM/EFSF combined issuance makes the rescue funds the largest sovereign, supranational, and agency issuer (SSA) in euro-denominated bonds.

The two funds have a unique profile in the market. Like government issuers, they seek to be transparent and to issue at the right time and in the right amounts. They also use a range of methods of issuance, such as bill auctions and taps of existing bonds. Yet the rescue funds also combine this approach with the flexibility typically practised in the sovereign, supranational, and agency space on issuance size and maturity per transaction.

Transparency creates trust in the market. Flexibility allows the funds to react to investor demand and market developments.

Marketing has been another necessary element of creating and keeping a strong market presence. Helping global investors understand the euro area's firewall had been a priority from day one: the first transcontinental trip Regling made as EFSF CEO had been to Asia, with regular stops there ever since – including to Japan in the wake of the tsunami that damaged the Fukushima nuclear reactors. His consistent outreach paid off. 'For the first two years, Asia bought 40% of our bonds, which is a very high share,' Regling said. 'It had a lot to do with our marketing efforts there.'

To succeed, ESM and EFSF debt also needs to perform well on the secondary markets, where previously issued bonds are traded. This requires excellent external credentials. To help maintain smooth trading, Regling sought to establish good relations with the Bank for International Settlements, the bank for central banks, which provides a secretariat for the international standard-setting body for banking regulation. That body, the Basel Committee on Banking Supervision, rated the firewall's debt a high quality liquid asset, allowing it higher

status in institutional investor portfolios, and gave the funds a zero-risk weighting – the same as the sovereign countries that provided the guarantees and capital¹⁶³.

To ensure their bonds remain liquid, the rescue funds frequently reopen issues. ‘We do tend to tap quite a bit. If we see a demand for a bond, we will reopen it,’ Fouquieray-Carrick said. ‘We have to make sure that the bonds are liquid enough, in order to reassure investors.’

Ruhl said the rescue funds cannot be complacent. Their funding needs are large, and will continue to be so for years to come, even if there are no new programmes.

‘In 2013, we raised €58 billion for the EFSF and €10 billion for the ESM. So in total €68 billion, which made us the fifth-largest euro issuer worldwide,’ Ruhl said. ‘That was only the third year of the EFSF and the first year of the ESM, so we were relatively new to the market. These marketing exercises were essential to extend and increase our investor base.’

¹⁶³ ESM (2014), ‘Basel Committee on Banking Supervision recognises ESM and EFSF securities as Level 1 high quality liquid assets (HQLA)’, Press release, 18 March 2014. <https://www.esm.europa.eu/press-releases/basel-committee-banking-supervision-recognises-esm-and-efsf-securities-level-1-high>

Focus

Awards for the ESM/EFSF funding team

Bond market specialists have recognised the ESM/EFSF bond-issuing team through a series of awards.

- December 2018: ESM wins GlobalCapital Award:
 - Best Supranational Euro Deal of the Year, for its €4 billion 5-year bond, issued in July
- May 2018: ESM/EFSF wins GlobalCapital Awards
 - 1st place: Overall Most Impressive SSA Funding Official – Siegfried Ruhl, ESM/EFSF head of funding
 - 1st place: Most Impressive Supranational Funding Official – Siegfried Ruhl

- May 2017: ESM/EFSF wins GlobalCapital Awards
 - 1st place: Overall Most Impressive SSA Funding Team
 - 1st place: Overall Most Impressive Funding Official – Siegfried Ruhl
- December 2016: ESM wins mtn-i Rising Star awards for N-bonds (mtn-i provides market information, news, and data for fixed income markets for issuers, investors, and banks.)
- May 2016: ESM/EFSF wins GlobalCapital Awards:
 - 1st place: Most Impressive Supranational Funding Team in Euros
 - 1st place: Most Impressive Supranational Funding Official – Siegfried Ruhl
 - 1st place: Overall Most Impressive SSA Funding Official – Siegfried Ruhl
- January 2016: ESM wins International Financing Review Award:
 - Issuer of the Year in the Sovereigns, Supranationals, Agencies and Regions category, earning special recognition for coping with huge growth: ‘Overnight, the body’s funding target shot up from €5 billion for the last four months of 2015 to €18 billion’¹⁶⁴
- May 2015: ESM/EFSF wins GlobalCapital Awards:
 - 1st place: Overall Most Impressive SSA Funding Team
 - 1st place: Most Impressive Supranational Funding Team in Euros
 - 1st place: Most Impressive Supranational Funding Official in Euros – Siegfried Ruhl
- January 2015: EFSF wins GlobalCapital Awards:
 - 1st place: Euro Supranational Deal of the Year, for its €4 billion 30-year bond issued in July 2014
- January 2014: ESM wins EuroWeek Award:
 - 1st place: Deal of the Year, for €7 billion, 1.25%, October 2018 bond, working with HSBC, J.P. Morgan, and Société Générale

¹⁶⁴ International Financing Review (2016), SSAR Issuer: *European Stability Mechanism*, online IFR Review of the Year 2015.
<http://www.ifre.com/ssar-issuer-european-stability-mechanism/21223502.fullarticle>

 Funding strategy, which began in Chapters 12 and 14, continues in ‘Focus – When bonds are better than cash’ in Chapter 25 and in ‘Focus – How do you solve a problem like a downgrade?’ in Chapter 29.

From bailout to bail-in: towards a new programme for Greece

19

We had problems finding a political consensus around what needed to be done. It took three years to get to the first kind of reluctant consensus in 2012. So, it was a very toxic domestic political situation.

George Papaconstantinou

Greek Finance Minister (October 2009–June 2011)

Greece was a recurring concern in the first years of the euro crisis. By January 2011, the three major rating agencies had all reduced Greece's debt to below investment grade. Credit downgrades continued until, by the end of July, Greece was the lowest-rated country in the world¹⁶⁵, cut off from market financing and left dependent on outside financial help.

European policy debates reflected this slide in market confidence, as optimism evaporated that Greece could emerge from the crisis on its own. Worries about the scope of Greece's economic challenges – and doubts about whether or not the faltering assistance programme could address them – took centre stage.

¹⁶⁵ Reuters (2011), 'Greece falls to S&P's lowest rated, default warned', 13 June 2011.
<https://www.reuters.com/article/us-greece-ratings-sandp/greece-falls-to-sps-lowest-rated-default-warned-idUSN1312685920110613>

2011

14 January

Fitch downgrade: BB+ from BBB-, the last of the three major agencies to rate Greek debt below investment grade.

11 March

At an emergency EU summit, leaders offer to ease pricing terms of the first programme, the Greek Loan Facility.

20 June

Eurogroup says that the country is unlikely to regain private market access by early 2012.

29 June

Parliament passes second fiscal consolidation bill after widespread protests and strikes.

July

The fourth review of the adjustment programme says pace of reforms has substantially slowed, and that recession is worse than projected.

21 July

Euro area leaders prepare for a second programme. EFSF to provide the EU's contribution, and debt restructuring to involve private sector.

2 October

Greece says it will miss key deficit targets agreed with its international lenders.

31 October

Prime Minister George Papandreou calls for a referendum on the rescue. It is cancelled three days later, and he resigns on 9 November.

11 November

Lucas Papademos is sworn in as new prime minister.

Euro area leaders didn't want to put more money into Greece just to enrich speculators who had bought its bonds. But private investors opposed being forced into forgiving debt owed to them by Greece. In the 2010 push to assemble the first rescue programme for Greece, international authorities had hoped this infusion of funds would be enough to stabilise the Greek situation and prevent contagion.

Disbursements from the first programme, via the Greek Loan Facility, were made in January and March 2011. At an emergency EU summit on 11 March 2011, leaders offered to ease pricing terms¹⁶⁶. They lowered the rates and extended the maturity of Greek Loan Facility loans – a step that gave Athens more breathing room to manage the tough reforms required.

Only a few months later, matters turned critical again. In conducting the fourth and final review of Greece's first programme, the troika of institutions – the ECB, IMF, and European Commission – warned in July of a let-up in reform implementation and a worse-than-expected recession¹⁶⁷. Given the lack of progress, there was less willingness to disburse more of the rescue funds that had become Greece's lifeline.

Deteriorating finances, a loss of competitiveness, and historically rigid industrial structures plagued the Greek economy. Many professions were stifled by restrictive regulation, making it hard for new entrants to do business. Tax evasion remained a major problem. Greek banks were also struggling to keep up with the challenges facing the economy.

Although Greece succeeded in bringing its deficits down considerably during the first rescue programme with the Greek Loan Facility, the country was still in trouble. The recession deepened.

¹⁶⁶ Statement by the Heads of State or Government of the Euro area – 11 March 2011, *The European Council in 2011*, p. 32, January 2012.

<http://www.consilium.europa.eu/media/21347/qcao11001enc.pdf>

¹⁶⁷ European Commission, Directorate-General for Economic and Financial Affairs (2011), 'The Economic Adjustment Programme for Greece fourth review – spring 2011', *European Economy Occasional Papers* 82, July 2011.

http://ec.europa.eu/economy_finance/publications/occasional_paper/2011/pdf/ocp82_en.pdf

In retrospect, the IMF pointed to a number of shortcomings in its first Greek programme¹⁶⁸. ‘Market confidence was not restored, the banking system lost 30 percent of its deposits, and the economy encountered a much deeper-than-expected recession with exceptionally high unemployment,’ the IMF would later describe this period in a 2013 evaluation. ‘The depth of ownership of the program and the capacity to implement structural reforms were overestimated.’ The report also noted that social and political turmoil undermined confidence.

Much of the latter half of 2011 was spent considering how to address Greece’s debt. When leaders acknowledged that Greece would need more money, they also made clear they would refuse to act unless financial markets agreed to absorb some of the costs. Until there was accord on how to do that, leaders weren’t prepared to put more money into solving Greece’s overarching economic problems.

Days before a crucial 20 June 2011 Eurogroup meeting, Greece’s finance ministry underwent a change at the top. Papaconstantinou was replaced as finance minister by Evangelos Venizelos, a political veteran. Whereas Papaconstantinou had been part of the rescue negotiations since Greece’s budget woes first emerged in 2009, Venizelos was brand new to the debt talks, but he was known for political savvy gained over a career that included stints as defence, justice, and transport minister. The hope was that he had the domestic clout to deliver on Greece’s promises, even if he didn’t have as much financial market expertise.

At that June meeting in Luxembourg, euro finance ministers conceded that Greece would not be able to borrow on its own any time soon. ‘[G]iven the difficult financing circumstances, Greece is unlikely to regain private market access by early 2012,’ the Eurogroup said in a statement after the meeting¹⁶⁹.

The admission raised the stakes: more money would be needed, but this time the Eurogroup determined that private sector bondholders would share the costs, which meant forgiving some of the debt Greece owed them. ‘Ministers agreed that the required additional funding will

¹⁶⁸ IMF (2013), *Greece: Ex post evaluation of exceptional access under the 2010 stand-by arrangement*, IMF staff country reports, 5 June 2013. <https://www.imf.org/en/Publications/CR/Issues/2016/12/31/Greece-Ex-Post-Evaluation-of-Exceptional-Access-Under-the-2010-Stand-By-Arrangement-40639>

¹⁶⁹ Statement by the Eurogroup on Greece, 20 June 2011. http://europa.eu/rapid/press-release_MEMO-11-426_en.htm?locale=en

be financed through both official and private sources and welcome the pursuit of voluntary private sector involvement,’ the 20 June statement said. In that same statement, they still held out hope that Greece could avoid a selective default through ‘the pursuit of voluntary private sector involvement in the form of informal and voluntary roll-overs of existing Greek debt at maturity’. Ultimately, the private sector involvement would take place in an exchange of outstanding debt the following year, in which bondholders swapped their existing bonds for new securities with a lower face value.

Despite what the euro area saw as slowing reform momentum, the Greek government pushed through a second fiscal consolidation package that included large spending cuts and tax increases at the end of June to meet its aid requirements. But parliamentary approval generated two days of protests that left hundreds of protesters and police injured. Protests had been a serious concern in Greece ever since demonstrations in May 2010 had left three dead in the wake of the signing of the agreement to initiate the first programme.

The Greek government was under pressure to hold firm to its commitments even as economic conditions worsened and domestic opposition to the reforms rose. The Commission said in its fourth review of the Greek Loan Facility that ‘reform implementation has substantially decelerated.’ It also found the recession to be deeper and more protracted¹⁷⁰. There was sympathy for the plight of the Greek workforce, suffering from the lengthy recession, tax increases, and high unemployment, but euro area leaders maintained that there was no other way to provide a lasting solution to the country’s years-long drop in competitiveness.

‘These are unprecedented, but necessary, efforts to bring the Greek economy back on a sustainable growth path,’ euro leaders said in a 21 July 2011 summit statement. ‘We are conscious of the efforts that the adjustment measures entail for the Greek citizens, and are convinced that these sacrifices are indispensable for economic recovery and will contribute to the future stability and welfare of the country’¹⁷¹.

¹⁷⁰ European Commission, Directorate-General for Economic and Financial Affairs (2011), ‘The Economic Adjustment Programme for Greece fourth review – spring 2011’, *European Economy Occasional Papers* 82, p. 9, July 2011.

http://ec.europa.eu/economy_finance/publications/occasional_paper/2011/pdf/ocp82_en.pdf

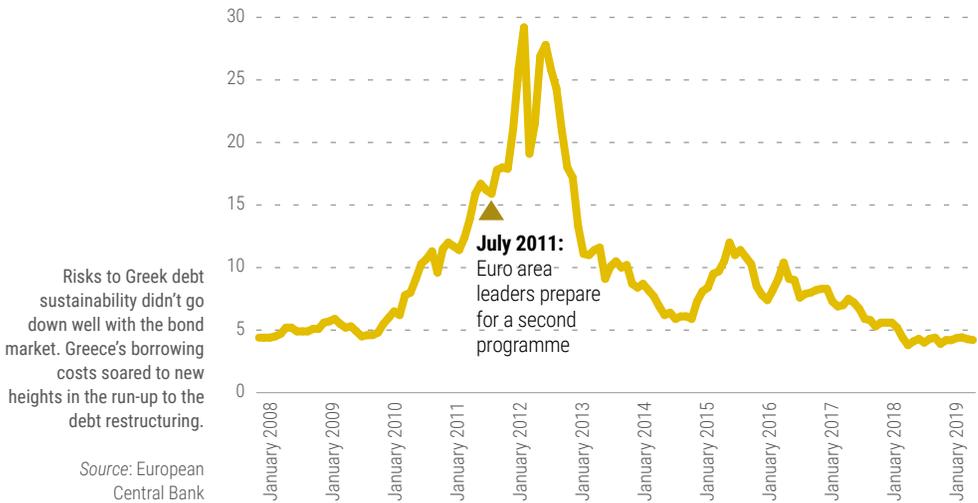
¹⁷¹ Statement by the Heads of State or Government of the Euro area and EU Institutions, 21 July 2011.

<http://feelingeurope.eu/Pages/euro%20area%20statement%202011-07-2011.pdf>

Against this tumultuous backdrop, Greece's second rescue programme began to take shape. Greece needed a big infusion of cash to pay its bills. At the July summit, euro area leaders agreed to start talks on more aid – provided that bondholders accepted losses in order to reduce Greece's debt burden¹⁷². There could be €109 billion available from IMF and European sources, the leaders pledged, but only if Greece stuck to its cuts and bondholders bowed to a 'voluntary' restructuring. For it to work, most private holders of Greek bonds would have to participate, even if they had the option not to.

10-year government bond yield – Greece

in %, monthly average



Soon after the summit, talks with bondholders got underway. For its backers, the debt exchange represented an essential step; for its detractors, it spelt financial market heresy. Greek stocks plunged, with the Athens Stock Exchange falling below 1,000 points on 8 August, the lowest in almost 15 years. Bond yields were rising precipitously.

¹⁷² Ibid.

Private investors warned that the proposed debt exchange would leave a catastrophic legacy for Europe, especially given the possibility of further losses in other countries. Josef Ackermann, CEO of Deutsche Bank, said that there were many investors in the US and Asia who would shun euro area bonds under these conditions, according to a 28 November 2011 article in Germany's Spiegel Online. 'We will be paying a high price for a long time to come for having violated the principle that European government bonds are risk-free,' said Ackermann, who was at that time chairman of the Board of Directors of the Institute of International Finance (IIF)¹⁷³.

IMF and EU officials had laboured with the IIF, a trade group representing the private creditors, to find a way to keep the exchange legally voluntary and thereby forestall an official declaration of default, while reaping enough savings to meet Greece's debt targets.

Bankers and private sector holders of Greek debt weren't alone in opposing bond writedowns. Sceptics feared that the debt swap could devastate the euro area's marketplace credibility. Trichet, former president of the ECB, had negotiated debt relief for underdeveloped countries as head of the Paris Club of creditor countries in the late 1980s and early 1990s, and saw sovereign debt writedowns, as first raised by Germany's Merkel and France's Sarkozy in 2010 in Deauville, as extremely dangerous as long as they were perceived as being the general rule for all vulnerable countries. By casting sovereign debt as no longer risk free, he argued, the euro area would undermine its work to rebuild market trust in troubled economies. On the practical side, it could sabotage the health of the very countries it was designed to rescue.

The prospect of imposing losses on bondholders 'was destroying all of our deterrent, all the deterrent of the EFSE, and also what we were doing with the ESM,' Trichet later said. He said the euro area was able to stabilise its reputation only when it made clear that debt writedowns for Greece would be a one-off, not a required part of any rescue programme.

¹⁷³ Spiegel Online (2011), 'A continent stares into the abyss', 28 November 2011. <http://www.spiegel.de/international/europe/euro-zone-on-the-brink-a-continent-stares-into-the-abyss-a-800285-2.html>

Trichet's resistance was part central banker caution and part European pride, said Lagarde, who had taken over as IMF managing director on 5 July 2011. 'For him it was just complete nonsense, an absurdity, and a dangerous path,' she said. 'He was concerned about the euro because he was the president of the ECB. But, as the former president of the Paris Club, which leads debt restructurings, most often of developing countries, it was just anathema to imagine an advanced country having to restructure its debt.'

Initial hopes of getting a second Greek programme in place by September proved unworkable, making global leaders nervous. On 26 September 2011, US President Barack Obama warned at a local question-and-answer meeting in California's Silicon Valley that Europe had not done enough to combat contagion, naming Greece as the possible trigger for the next systemic shock. 'They have not fully healed from the crisis back in 2007 and never fully dealt with all the challenges their banking system faced. It's now being compounded by what's happening in Greece,' Obama said. 'They're going through a financial crisis that is scaring the world. And they're trying to take responsible actions, but those actions haven't been quite as quick as they need to be'¹⁷⁴.

Back in Europe, fears of a Greek exit from the euro, stoked by the Luxembourg castle meeting in May, became more prevalent¹⁷⁵. In October, the government in Athens said Greece would not be able to meet the 2011 or 2012 deficit targets it had agreed with its international creditors because of the unexpected harshness of the recession.

Crisis diplomacy in late October focused on the bond writedowns, seen as the key to unlocking more aid for Greece. To win the investment community's acceptance of the unprecedented step and prevent it from sapping confidence in the bonds of other distressed countries, euro area leaders made the case that the Greek restructuring was a one-off due to the 'exceptional'¹⁷⁶ nature of Greece's economic troubles.

¹⁷⁴ US, Office of the Press Secretary (2011), 'Remarks by the president in town hall with LinkedIn', 26 September 2011.
<https://obamawhitehouse.archives.gov/the-press-office/2011/09/26/remarks-president-town-hall-linkedin>

¹⁷⁵ Spiegel Online (2011), 'Greece considers exit from euro zone', 6 May 2011.
<http://www.spiegel.de/international/europe/athens-mulls-plans-for-new-currency-greece-considers-exit-from-euro-zone-a-761201.html>

¹⁷⁶ Euro summit statement, 26 October 2011.
https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/125644.pdf



Portuguese Finance Minister Vítor Gaspar (left) and European Central Bank President Jean-Claude Trichet (right), with EU Economic and Monetary Affairs Commissioner Olli Rehn (centre) on 22 October 2011 amid discussions on Greek debt.

Credit: John Thys/AFP

‘All other euro countries solemnly reaffirm their inflexible determination to honour fully their own individual sovereign signature and all their commitments to sustainable fiscal conditions and structural reforms. The euro area Heads of State or Government fully support this determination as the credibility of all their sovereign signatures is a decisive element for ensuring financial stability in the euro area as a whole¹⁷⁷, the leaders said in a summit statement on 26 October 2011.

In Greece’s case, the leaders said that bondholders would have to take a roughly 50% haircut as part of a new aid package. The leaders set a goal of end-2011 to sign off on the programme, with the bond swap scheduled for early 2012. Haunted by the threat of a market panic, the October summit statement acknowledged the global worries and proposed what was intended to be a comprehensive plan because ‘further action is needed to restore confidence¹⁷⁸.

¹⁷⁷ Ibid.

¹⁷⁸ Ibid.

At this point, Greek Prime Minister Papandreou surprised everyone on 31 October 2011 by calling for a referendum on the outline of the rescue plan¹⁷⁹. At a 3 and 4 November summit of the Group of 20 countries in Cannes, France, Merkel and Sarkozy led the euro area in laying down the gauntlet, telling the Greek leader that his referendum would in effect be a yes or no vote not just on the rescue, but on Greece's euro membership.

When, on the eve of the summit, Papandreou arrived unexpectedly to inform Sarkozy and Merkel about the referendum plan, they opposed it immediately, the IMF's Lipsky said. 'The impression was left that in addition to objecting to the proposal to hold a referendum, the two key leaders had lost confidence in him personally.'

Papandreou called off the referendum on 3 November and Greece's political class moved to form a unity government without him¹⁸⁰. On 10 November, Papandreou formally resigned¹⁸¹ and the next day former ECB Vice President Lucas Papademos was sworn in as prime minister.

- ~ Greek programme history, which began in Chapter 3, continues in Chapters 22, 36, 37, and 38.

¹⁷⁹ *Financial Times* (2011), 'Greece calls referendum on EU bail-out', 31 October 2011. <https://www.ft.com/content/68748490-03f5-11e1-98bc-00144feabd0>

¹⁸⁰ Reuters (2011), 'Greek PM ready to go, dump referendum, for euro deal', 3 November 2011. <https://uk.reuters.com/article/uk-g20/greek-pm-ready-to-go-dump-referendum-for-euro-deal-idUKTRE7A20DG20111103>

¹⁸¹ *New York Times* (2011), 'Greek leader calls off referendum on bailout plan', 3 November 2011. <http://www.nytimes.com/2011/11/04/world/europe/greek-leaders-split-on-euro-referendum.html>

European ‘bazooka’: the \$1 trillion question

20

The markets had a huge influence on our discussions. [Our firepower] had to be impressive enough to calm the markets.

Jean-Claude Juncker

President of the European Commission (since November 2014)

By December 2011, euro area leaders figured they had put together enough euros to reach the symbolic figure of \$1 trillion in backstop resources. They hoped that amount would calm markets concerned that Spain or even Italy might represent Europe’s next weak link. Not only did they agree to reinforce the EFSF’s guarantee structure and add new leverage tools, they also pulled forward the ESM’s entry into force to mid-2012, so the euro area would soon have a robust and capital-backed firewall instead of the EFSF’s temporary guarantees.

When they met on 9 December, the leaders added some finishing touches aimed at making the promise of \$1 trillion more credible¹⁸².

¹⁸² Statement by the euro area Heads of State or Government, 9 December 2011.
https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/126658.pdf

For the total commitment to hold up, a number of factors would need to come together. As IMF members themselves, they would lobby for the fund to receive a €200 billion temporary increase from euro area member states. And they pledged to review the capacity question again in March 2012.

Unfortunately, the headline number's foundations were not completely sturdy. Former ECB President Trichet put the problem succinctly: 'The amount of money that was really mobilised was significantly more meagre than what was promised and, in my view, was one of the reasons why the Europeans lacked the level of credibility that would have been necessary given the circumstances.'

First, the IMF assertion materialised at less than initially announced. In a mid-December meeting, finance ministers heralded only a €150 billion increase in the IMF, to be funded by currency union members. While a few EU Member States that were not in the euro area were willing to take part, the UK resisted¹⁸³ so the initial €200 billion figure became unworkable.

Meanwhile, the speedier ESM debut raised many questions. Now that the permanent firewall would be running in parallel to the EFSE, was there any chance the capacity of the two funds could be combined? This in turn raised the stakes for the March capacity review, as EFSF CEO Regling acknowledged in a 17 December interview with Al Jazeera, where he tried to quiet the drumbeat of questioning whether or not Europe was willing to act.

'Markets will understand that there is enough "firepower" – i.e., immediately available financial assistance to any euro area country – if needed,' Regling said, specifying that this would include any country, not just the three that were already seeking aid¹⁸⁴. 'Firepower is increasing, and also, importantly, the summit decided to review the availability of firepower, if that is necessary, by March 2012. By then we will know whether more is needed. At the moment I think we have more than enough.'

¹⁸³ *Guardian* (2011), 'UK to resist calls to give IMF more funds for euro-bailout', 14 December 2011. <https://www.theguardian.com/business/2011/dec/14/uk-resists-calls-imf-bailout>

¹⁸⁴ *Politique-Actu* (2012), 'For Europe: "The firepower is there": An interview', 26 January 2012. <http://www.politique-actu.com/dossier/europe-firepower-there-interview-klaus-regling-interviewed-sami-zeidan/370687/>

In the interview, Regling pushed back against the idea that resources were insufficient to stand behind the euro with both Italy and Spain in the market’s crosshairs. Even in a worst-case scenario, the fears of actually needing a trillion euros in a short timeframe were unfounded, he said. ‘It’s not correct to look at the total outstanding debt,’ Regling told the news channel. ‘When we look at firepower, the question is what may be needed over the next 12 months, maybe the next 24 months, but no more than that,’ he explained. ‘We know, for instance, that Italy and Spain have about €600 billion in maturing debt over the next two years. So that’s the appropriate figure for the comparison with the firepower of the EFSF’

Doubts remained. Euro area authorities were quietly mulling over Italy’s situation. The Italian economy had been relatively stagnant for most of the 2000s, with banks struggling and the country’s debt high. The crisis had pushed bond yields up to worrying levels. European policymakers wondered if a rescue programme would be needed, and, if so, if it could be big enough to make a difference.

‘A programme was discussed back then. In fact, I remember it was the topic of the moment at the Cannes Group of 20 in November 2011,’ said Grilli, the Italian deputy finance minister at the time, who would become finance minister in July 2012.

In Cannes, the leaders ended up encouraging Italy to work more closely with the IMF rather than recommend that the country take the extra step of requesting aid. The end-of-summit communiqué said: ‘We support the measures presented by Italy in the Euro Summit and the agreed detailed assessment and monitoring by the European Commission. In this context, we welcome Italy’s decision to invite the IMF to carry out a public verification of its policy implementation on a quarterly basis’¹⁸⁵.

The ESM’s Nicola Giammarioli, who was at the IMF at the time, now heads the ESM strategy team, and has been mission chief to Greece and Ireland. He said that precisely because Italy was so big, with

¹⁸⁵ Group of 20 (2011), ‘G20 Leaders Summit’, Cannes, 3 and 4 November 2011. Online version published by the Organisation for Economic Co-operation and Development (OECD), Paris. <https://www.oecd.org/g20/summits/cannes/Cannes%20Leaders%20Communiqu%C3%A9%204%20%20November%202011.pdf>

sufficient resources, it was able to find a solution from within. And because Italy – like most euro area countries – maintained good relations with financial markets throughout the crisis, it did not face the same loss of access to borrowing that other euro area member states encountered when spreads began to widen.

The exaggerated fears for Italy would not be borne out, but, as long as the euro area leaders tried to keep the joint rescue capacity small, there was equal pressure from financial markets to question if it would be enough to protect the euro area from a meltdown. The cascade of crises in the US had persuaded markets to be wary of small-scale relief efforts.

Shock and awe characterised the US plan, said IMF Managing Director Lagarde. The then-US Treasury secretary, Henry ‘Hank’ Paulson, had famously told colleagues in 2008 he was looking for a ‘bazooka’ to blast at the market and turn sentiment around¹⁸⁶. That became the \$700 billion Troubled Asset Relief Program – a number chosen in a bid to exceed the market’s expectations.

But that approach was foreign to Europe, Lagarde said. ‘That was very much the hallmark of the US. The go big or go home approach to life. Tim Geithner and others on the US side were always advocating bigger than big if you can. Whereas, in Europe, we’re a little bit more cautious and concerned because we knew that member states were being drawn into something that was not necessarily in their respective purview, because it was new and different.’

Regling made the point that, if you assumed the ESM would get a full fresh start and included all past commitments, the euro area already had €800 billion available: about €50 billion remained in the EFSF programmes for Ireland and Portugal, about €100 billion in EFSF funds were already earmarked for Greece, and the euro area also had its incoming €500 billion permanent firewall plus the IMF’s €150 billion.

¹⁸⁶ *New York Times* (2008), ‘Paulson’s itchy finger, on the trigger of a bazooka’, 8 September 2008. <http://www.nytimes.com/2008/09/09/business/09sorkin.html>

But just days before the end-March 2012 capacity review, the total firepower that leaders planned to deploy was still an open question.

If the euro area did nothing, total firewall capacity would be capped at €500 billion, with the EFSF’s existing €192 billion in commitments subtracted from the ceiling to make only about €300 billion available for use. Under the middle-ground option, the ESM could start afresh, but the EFSF would be capped at what had already been committed. For maximum effect, the euro area could decide that, for the year until the EFSF stopped accepting new programmes, the firewall would have access to its full €440 billion capacity on top of the €500 billion coming in with the ESM.

‘The ECB welcomes the commitment of Europe’s leaders to regularly review the lending capacity of the ESM and urges them to quickly agree on a significant increase of the resources of the ESM by combining the lending capacity of the ESM and the EFSF’ said Peter Praet, a member of the ECB’s Executive Board, in a March 2012 article published by a European financial markets conference¹⁸⁷.

Just one week before the 30 March meeting in Copenhagen, a draft circulated widely in the press suggested the maximalist issue would win the day. The EFSF’s roughly €240 billion in unused capacity could be tapped ‘in exceptional circumstances following a unanimous decision of euro area Heads of State or Government notably in case the ESM capacity would prove insufficient’¹⁸⁸. But that language did not occur in the final draft, meaning the potential maximum ceiling of combining the two funds to make €940 billion was never enshrined in policy.

Instead, finance ministers went for the middle option. They agreed on a combined ceiling for the EFSF and ESM of €700 billion: the full permanent firewall plus the roughly €200 billion that had already been committed from the temporary backstop. Their statement also echoed the €800 billion number that Regling had

¹⁸⁷ Eurofi, Praet, P. (2012), ‘Deleveraging and economic growth in the EU: Key factors for success’, p. 8, 29 March 2012. http://www.eurofi.net/wp-content/uploads/2012/08/EUROFI_DK_NEWSLETTER.pdf#page=8

¹⁸⁸ Reuters (2012), ‘Euro zone to back higher combined bailout fund: Draft’, 29 March 2012. <https://www.reuters.com/article/us-eurogroup-firewalls/euro-zone-to-back-higher-combined-bailout-fund-draft-idUSBRE82S13O20120329>

been using in the markets, by adding on the €53 billion paid out of the Greek Loan Facility and the €49 billion paid out of the EU-wide European Financial Stabilisation Mechanism. 'All together the euro area is mobilising an overall firewall of approximately EUR 800 billion, more than USD 1 trillion,' the Eurogroup said in a statement¹⁸⁹.

The firepower debate was finally over¹⁹⁰.

¹⁸⁹ Statement of the Eurogroup, 30 March 2012.

https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/129381.pdf

¹⁹⁰ Reuters (2012), 'Eurogroup statement on EFSF/ESM lending capacity', 30 March 2012.

<https://www.reuters.com/article/eurogroup-firewalls/text-eurogroup-statement-on-efsf-esm-lending-capacity-idUSL6E8EU3FR20120330>

The ESM takes shape: 'something fresh'

21

Despite being pushed to the limits of stress and physical exhaustion, you sit in the office at night and have an idea. You go out and it becomes part of European history. There's a high personal cost to it, but still it was, from a professional perspective, unbelievably rewarding.

Rolf Strauch
ESM/EFSS Chief Economist

As the temporary fund prepared in 2012 to evolve into its permanent form, the ESM faced the same challenges as a start-up in the private sector: how to retain the nimble, entrepreneurial spirit of the early days while providing structure, and a career path and positive working environment for the professional staff.

Regling, chief executive of the EFSS, shepherded the permanent firewall into being. Throughout this transition, Regling sought to maintain the cultural middle ground between a freewheeling entrepreneurial spirit and a rules-bound public institution, according to EFSS Secretary General Anev Janse.

'Klaus said, "I know what I don't want. I don't want to recreate existing financial institutions. I want something new, something fresh,"' Anev Janse recalled. 'He also felt the idea of creating a "modern international financial institution" was a bit intangible.'

A permanent institution brought the need for a longer planning horizon and a host of questions about recruitment, employee retention, workforce development, and office culture. As with the EFSF, the timeline for setting up the full-scale ESM was short. Initial plans in November 2011 envisaged an 18-month launch phase.

Under the exigencies of the crisis, however, the official start date had been brought forward to mid-2012, shrinking the preparation time. In December, at the same time as the firewall made its first disbursement to Spain, it moved into its permanent headquarters. Then, in January 2013, it acquired a workforce, taking over all the previous employees of the EFSF as well as integrating those seconded from other institutions and recruited from the private sector.

Chief Economist Strauch, who was loaned from the ECB at the EFSF's inception, said the move to the ESM involved a big shift from the minimalist mindset at the firewall's start. The euro backstop was supposed to be a temporary mechanism that would not be used and would later be disbanded. But the currency area's needs required a change of plans. 'My original idea was that I would come for one year,' Strauch said. 'Now I have a permanent contract. And we have loans to Greece until 2060 or beyond.'

As head of human resources and organisation, the EFSF brought in Sofie De Beule-Roloff, a Belgian with a background in the airline industry who had been helping companies establish in Luxembourg. When she joined in June 2012, there was no human resources division and staffers worked under an array of different contracts. Because the EFSF had been created on the fly, the basic infrastructure that is common even in small firms was patchy. This needed to change as the ESM came into being.

'Well, the daunting challenge was there was no HR department,' De Beule-Roloff said. 'When I joined I was employee number 23 and I had a target to reach 75 staff members by the end of that year. But before we could do that, I had to create a structure to accommodate us all. It was like building a house from the ground up.' That included developing a health insurance, pension, and social security scheme. The EFSF had been established as a company under Luxembourg law and was part of the national system. But as an international institution, the ESM would have to set up its own structures.

'Suddenly you don't have health care anymore, you have no retirement scheme, you have no compensation or benefit schemes, no

employment rules,’ De Beule-Roloff said. ‘Because we were no longer directly bound by any national legislation, we needed to set up our own internal rules and practices.’

A first task was to rethink what to outsource – for example back office functions such as payroll and contract preparation – and determine which areas required in-house expertise. Once those skill sets were identified, the ESM strove to recruit a pool of talented people whose careers might grow alongside the institution.

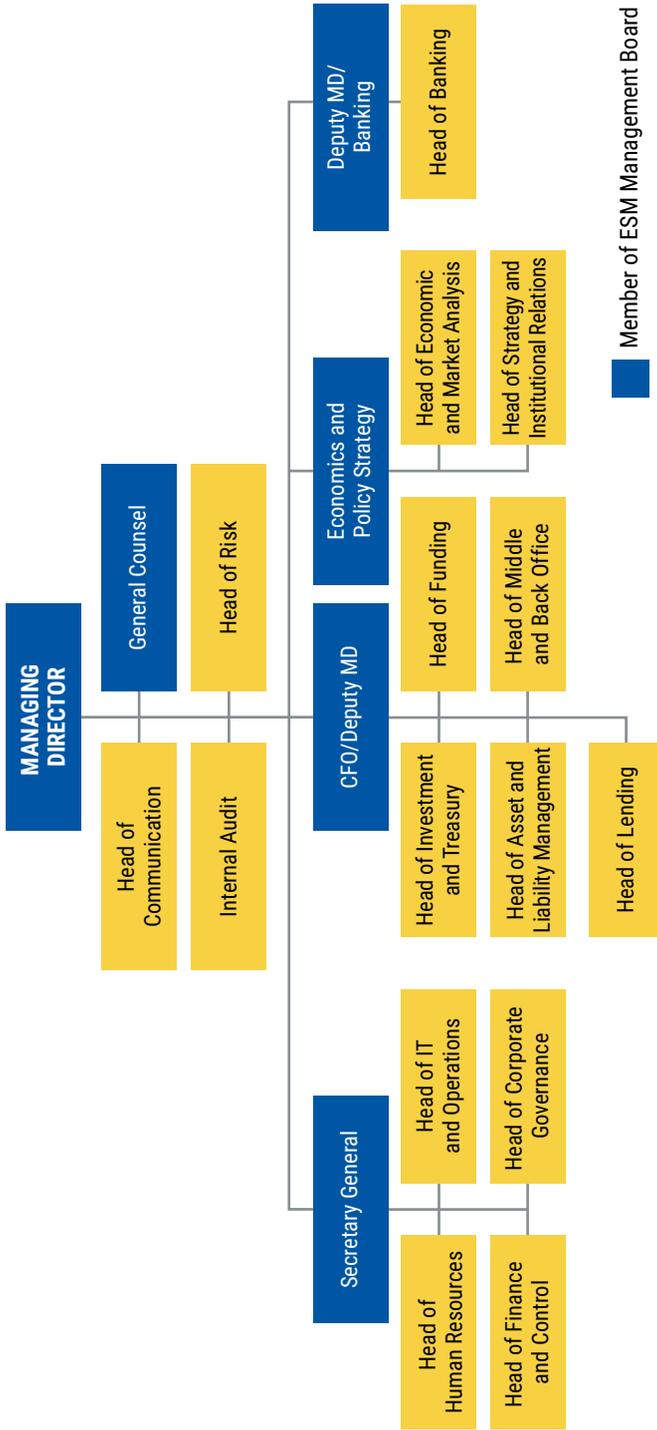
As an international organisation, the ESM is unlike EU institutions in that it does not require new hires to have EU citizenship. To ensure it could attract top staff, the ESM decided to set no national hiring quotas. The only stipulation is fluency in English, the international language of finance, which has been the working language since day one of the EFSF. While staff converse in their native languages as part of the daily ebb and flow, the English-only principle has been especially important for all written documentation, ensuring nothing gets lost in translation. The worldwide talent pool brings other benefits too, from understanding European economic developments in a global context to smoothing funding operations outside Europe.

For the early staffers, the demands of the job added up to sleepless nights, last-minute train trips and flights, and weekends away from family and friends – with agendas and policy planning routinely upended by the latest economic statistic, move in the bond market, or political utterance. It was a journey into the unknown, with all the attendant exhilaration and stress.

Blondeel, who became the rescue fund’s chief corporate officer, said it took a while to strike the right work/life balance, especially when the fund was in its infancy. On her own in Luxembourg before her husband relocated, Blondeel said the start-up days were marked by wall-to-wall work.

With experience in setting up a French public agency and in modernising the administration of the debt office, Blondeel called it a ‘natural move’ to lend her expertise to the fledgling rescue fund. ‘I very much enjoyed the freedom, positive stress, and pioneering spirit that united all the EFSF early joiners,’ she said. ‘It was a strange life, because my family was still in France. But, as is the case for many people, I would work hard during the week and come back home during the weekend to see my family.’

ESM organisational chart (2012)



The ESM, as seen in late 2012, was an institution in transition. It would officially take on its workforce in 2013 and bring in-house a number of operations.

Source: ESM

Attracting the high calibre of staff needed hasn't always been easy. As the second smallest country in the EU, Luxembourg doesn't have the supply of workers, or jobs, of its larger neighbours. Much of the Grand Duchy's workforce commutes in from neighbouring Belgium, Germany, or France, but, for those recruited from further afield, relocation often poses a problem for families. In addition, while English is the lingua franca of the ESM, German and French are more commonly heard in other workplaces – limiting the options for trailing spouses who don't speak those languages. To smooth things for dual-career couples, the ESM offers German, English, French, and Luxembourgish language courses and helps to find jobs for partners.

‘We do a lot to integrate staff members' families, because Luxembourg is not an easy place for partners to find suitable jobs,’ De Beule-Roloff said. ‘We are trying to help families integrate here over time so they can stay. Luxembourg is not an obvious choice for many people.’

From the start, the ESM has sought to include a mix of personal and professional backgrounds. Staff come from the public and private sectors, and there has been a bid for diversity in terms of age, sex, and national origin. About 25% of the staff are hired locally, although they may not necessarily be citizens of Luxembourg. By 2018, the ESM had staff members who hailed from 42 countries and spoke 33 languages. Some 60% had joined the institution from the private sector, and 40% from public institutions.



ESM employees devote one day annually to a discussion of the fund's internal culture and values. Here is a scene from the 2015 event.

Credit: ESM

‘We do not recruit people who are routine job seekers,’ De Beule-Roloff said. ‘You need people with a can-do attitude and you need people to trust each other, who are willing to make decisions even when they don’t hold all the cards.’

Staff retention has become crucial as the ESM puts down institutional roots. What is particularly important, De Beule-Roloff said, is to maintain the institutional memory by retaining experienced people who could leave large knowledge gaps in their absence. The ESM also promotes mobility within the organisation. In keeping with its all-hands-on-deck mentality and because of its evolving mission, internal job changes are not unusual. For example, if someone from a middle office function wanted to take a funding role, then move from funding to investment, the organisation would support the move – provided the applicant had the right credentials.

This philosophy infuses the senior management team. In 2016, with the work of crafting new tools and programmes mostly complete for the time being, the ESM rejigged some management duties. CFO Frankel swapped some responsibilities with Anev Janse, and the Board separated its investment and funding lines of reporting. Part of the logic was to retain these expert staff who had been with the institution for the past six years, but keep their jobs interesting with a new focus.

As the institution hired, senior management took the time to reflect on how to build a corporate culture conducive to accentuating the upside of working on behalf of the European public while cushioning the inevitable stresses.

The fund turned to Deborah Henderson of Centre for Inspired Leadership, a Canadian-born consultant based in London, to help to hone a corporate culture that would bring out the best in all, taking into account the challenges of its systemic, political, and economic environment. Henderson recognised early on that the rescue fund – owned by euro area governments, responsible to them and the public, and inextricably connected with banking and the financial markets – would need to work relentlessly at developing and maintaining its diverse culture within such a context.



The ESM's seven core values were drawn up by the staff, not imposed by management. Here, Managing Director Klaus Regling takes part in the Values Day discussions in 2015.

Credit: ESM

The ESM ‘has so many unique features to it that are different from most organisations, even for civil service organisations, by virtue of its origins, its structure, and its stakeholders, and because it’s in the centre – a perceived safe haven – in any euro financial storm,’ Henderson said. ‘It is an organisation that will constantly need huge investment in its culture and in its leadership to navigate the complexities and uncertainties of its environment and maintain its overall sense of purpose.’

Henderson first surveyed the EFSF’s then-25 employees. She drew on a popular business assessment tool to tap into employees’ perceived values, aspirations, needs, and attitudes and to identify obstacles to better performance and increased job satisfaction.

The tool was designed around the premise that employees often know better than their higher-ups how to achieve their maximum potential. The online survey asked three questions: about the employee’s primary personal values, the values he or she perceived at the EFSF, and the values needed to enhance the organisation’s performance.

Employees felt that the rescue fund should be sure to cultivate a culture of teamwork, openness, and employee recognition, as well as continuous improvement, while focusing on the shared vision. Many of the 21 employees who filled in the survey saw the EFSF as a unique opportunity to help Europe through troubled times.

However, there were cautionary signs as well. Staff saw only one value – commitment – embedded in the organisation as it was then constituted. Long hours in the office or on the road were viewed as the rescue fund's biggest drawback, pointing to the gruelling workload as a possible source of burnout. Given the crisis conditions of the start-up, it was understandable that some fear-driven values also showed up – such as confusion and internal competition.

It was an opportune time to assess the mood within the organisation, and the EFSF responded by instituting seven values that now embody the rescue fund's core culture: health and well-being, respect, excellence, teamwork, creativity, making a difference, and ease with uncertainty¹⁹¹. These fundamental tenets are flanked by a commitment to diversity.

The senior management endorsed the conclusions from the online survey and follow-up dialogue sessions. Importantly, the resulting cultural commitments evolved from within the organisation instead of being imposed from above. Regling praised Henderson's approach to shaping the internal discussions. 'She said if you don't work on building your own culture by design, you will still have a culture by default – but not usually the one you want,' Regling said.

Although the euro economy is enjoying relatively favourable economic conditions today, in part due to the work of the EFSF and ESM, everyone who works at the firewall is keenly aware of what was so recently at risk. The ESM's Giammarioli grew up in Italy with an Italian father and Finnish mother, at a time before Finland joined the EU. Europe's past was etched into his family's history. 'My two families, 3,000 kilometres apart, suffered greatly during World War II,' Giammarioli said. 'Europe has guaranteed the last 75 years of peace, prosperity, and growth. In the crisis, that came under threat. I see myself as a small actor in this big picture, trying to help principles that were developed decades ago move forward.'

~ Institutional history, which began in Chapter 11, continues in Chapters 28 and 30.

¹⁹¹ ESM (2018), 'Working at ESM', December 2018. <https://www.esm.europa.eu/careers/working-esm>

A 'big mistake': Greece's second rescue stumbles

22

Once there was significant involvement of the EFSF/ESM, the whole tone of the debate about debt restructuring changed completely. It became less a question of plugging the existing holes, which was more or less what the Greek Loan Facility did, and more of having some kind of anticipatory precautionary cash in the till.

Thomas Wieser

Chairman of the Eurogroup Working Group
(October 2011–January 2018)

With former ECB Vice President Papademos installed as interim prime minister in November 2011, Greece quickly began readying itself for a second rescue programme. First on the agenda was the proposed private sector debt exchange. An effort to put a deal together in late 2011 had collapsed, so negotiations needed to start again on a bigger scale¹⁹². In February 2012, the Greek government announced that it had hammered out the terms with representatives of private sector bondholders, clearing a key hurdle.

¹⁹² Global Restructuring Review (2017), 'Overview: Restructuring of Greek sovereign debt', 10 March 2017. <https://globalrestructuringreview.com/benchmarking/the-european-middle-eastern-and-african-restructuring-review-2017/1137879/overview-restructuring-of-greek-sovereign-debt>

2012

21 February

Eurogroup reaches outline deal on second assistance package for Greece. Formal accord follows on 14 March.

9 March

- Sovereign debt restructuring (private sector involvement) of around €199 billion begins, concluding on 25 April.
- First tranche of €34.6 billion is disbursed.

6 May

Parliamentary elections are held, but with no majority winner. Coalition talks fail, so new elections are set for June.

17 June

Antonis Samaras wins June elections. He is sworn in as new prime minister three days later.

27 November

Eurogroup overhauls the country's second programme and endorses potential future debt relief measures.

2013

5 June

IMF Executive Board reviews Greece misreporting, and discusses ex post evaluation of 2010 stand-by arrangement.

October

10-year government bond yield steadies below 10%.

2014

10 April

Greece returns to international capital markets with a 5-year bond issue, raising €3 billion.

8 December

Prime Minister Samaras seeks early parliamentary appointment of next president.

9 December

Athens stock market experiences biggest one-day fall since 1987.

29 December

Government collapses after failing to elect a new president.



Greek Finance Minister Evangelos Venizelos (left) speaks with German Finance Minister Wolfgang Schäuble at a Eurogroup meeting in February 2012 in Brussels as Greece’s second programme takes shape.

Credit: European Union

By the end of the month, the other pieces were in place. As with all euro area aid programmes, the second rescue agreement came with conditions that would need to be implemented over time. These included pension system reform, higher taxes, minimum wage cuts of more than 20%, the scrapping of 150,000 public sector jobs, and more flexible types of employment. Once Greece had signed up to these conditions and permanent on-the-ground monitoring of its compliance by the troika, the Eurogroup signed off on the follow-up programme¹⁹³.

Formal approval came on 14 March 2012¹⁹⁴. In contrast to the ad hoc nature of Greece’s first rescue, this second rescue came from the now fully operational EFSE. Totalling around €130 billion plus leftover IMF and EU funds from the first aid effort, the funds were originally scheduled for disbursement between 2012 and 2014, although as with many of Greece’s accords with the euro area, this schedule would be renegotiated later in the year. The IMF approved an extended fund facility for Greece and the release of its first instalment on 15 March.

¹⁹³ Eurogroup statement, 21 February 2012. https://www.esm.europa.eu/sites/default/files/2012-02-21_eurogroup_statement_bailout_for_greece.pdf

¹⁹⁴ Statement by the President of the Eurogroup, Jean-Claude Juncker, 14 March 2012. http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/128941.pdf

On 9 March, the private sector debt exchange deal, or private sector involvement, got underway. The writedowns went ahead on a 'voluntary' basis, sparing Greece from a disorderly default and the ensuing chain reaction of financial consequences. Participating investors accepted writedowns of 53.5% of the principal amount of their existing bonds, in exchange for a package of new Greek bonds, short-dated EFSF securities, and extra securities linked to Greece's GDP growth¹⁹⁵. Out of a total of €206 billion in bonds eligible for the offer, approximately €199 billion, or 96.9% were exchanged, easily surpassing the 75% minimum needed for the operation to go ahead¹⁹⁶.

It was the biggest sovereign writedown in history, reducing Greece's outstanding debt by about €107 billion¹⁹⁷. Yet it went through smoothly, because markets had had plenty of time to prepare for it. Backers of the haircuts hailed a turning point in the crisis response. Those who predicted the policy would trigger a financial market crash 'have been proven wrong. Nothing bad happened,' former German Finance Minister Schäuble said. 'This is an important principle, as it ensures that investors take risks into consideration, even when purchasing government bonds, and allows free-market mechanisms to highlight any need for corrective measures.'

¹⁹⁵ Reuters (2012), 'Factbox: Terms of the Greek bond swap laid bare', 7 March 2012. <https://www.reuters.com/article/us-greece-swap-factbox/factbox-terms-of-the-greek-bond-swap-laid-bare-idUSTRE8260K620120307>

¹⁹⁶ Greece, Ministry of Finance (2012), Press release, 11 April 2012. <http://www.pdma.gr/greekbonds/index.php/2012-05-28-15-51-31/2012-05-28-15-52-10/2012-05-28-15-54-7/2012-05-28-15-55-55/2012-05-28-16-01-51/category/24-press-releases?download=412:11-april-2012>

¹⁹⁷ ESM (n.d.), 'What was the private sector debt restructuring in March 2012?'. <https://www.esm.europa.eu/content/what-was-private-sector-debt-restructuring-march-2012>

Focus

€15 billion and 10 minutes to spare

Behind the scenes of the biggest sovereign debt restructuring in history, which began on Friday 9 March 2012, EFSF lawyers, the lending team, and debt managers saw to it that the transaction would go through without a hitch. Figuring out the details required everyone to work together at top speed.

The bonds had to be in the Greek settlement system before the weekend so that the first set of investors could exchange their old bonds on Monday for the new EFSF-provided, as well as other, securities¹⁹⁸. The size and scale were far beyond normal market operations. 'This was a very unique exercise in high amounts with plenty of bondholders,' said Ruhl, the EFSF head of funding. And the stakes were enormous – if anything went wrong, it could destabilise banks across Europe.

'The private sector involvement was agreed to take place over the weekend, so we had to deliver the bonds by Friday evening,' Ruhl said. The closing time was 17.30 for the settlement process, but the bonds couldn't move until all of the authorisations were in place, which depended on Greece delivering a final signature on Friday afternoon.

To get the operation started, Greece had to create about €15 billion in Greek government bonds – but the timing was incredibly tight, according to the rescue fund's Chief Economist Strauch. 'There was a call at 17.00 where I told them essentially: if you don't move so we can do this now, the transaction will not take place,' Strauch said. 'They had to run to make it happen.'

A broken fax machine at the Greek finance ministry added to the suspense of what was already a race against the clock. The EFSF sent over a document for the Greek officials to sign, but the finance ministry couldn't fax it back. In a scramble, the officials found a working machine at Greece's debt management office and faxed the signature from there. The team held its breath.

'We managed to send our bonds at absolutely the last minute, to an account at the Bundesbank, and from there they would go to the Bank of Greece,' Strauch said. 'There was the back and forth with the signatures and the clock was ticking. I think only 10 minutes before, at 17.20, I called the guy in Frankfurt to hit the button and send them over to Greece [...] and the bonds arrived.'

¹⁹⁸ Greece, Ministry of Finance (2012), Press release, 11 April 2012. <http://www.pdma.gr/greekbonds/index.php/2012-05-28-15-51-31/2012-05-28-15-52-10/2012-05-28-15-54-7/2012-05-28-15-55-55/2012-05-28-16-01-51/category/24-press-releases?download=412:11-april-2012>

Second Greek programme (2012–2015)

- Initial programme amount:** €164.5 billion
- Total amount disbursed:** €153.8 billion, of which the EFSF disbursed €141.8 billion
- Lenders:** EFSF, IMF
- Final weighted average maturity (EFSF loans):** 32.45 years
- Key legislated reforms:** labour market, income tax, public administration, social protection, health system, public financial management, business environment

The private sector involvement exercise marked the first use of funds from Greece's EFSF programme. Policymakers then approved a tranche of cash payments, which were paid out in several instalments between March and June. Around the middle of the year, however, things began to slow down.

Greek voters returned to the polls in May 2012, but no party won a parliamentary majority. After a follow-up election six weeks later in June, it became Antonis Samaras's turn to get a coalition up and running. To be his finance minister, Samaras turned to Yannis Stournaras, a university economics professor who also ran a private sector think tank.

Stournaras had a technocratic background and was acquainted with many of the key players from his time on the EU committee of finance ministry deputies in the late 1990s. When Greece was preparing to join the euro, he had sat between future EFSF CEO Regling and future ECB President Draghi under EU protocol order.

'The fact that I knew all of these people helped a lot,' Stournaras said. 'I had a strong opinion about what should be done – I said, first of all we have to restore credibility before we ask for anything.'

As soon as the new government was in place, talks began in July 2012 about how to push ahead with the programme, which had stalled during the run-up to the elections and subsequent change in government. In October, European finance ministers paired encouraging words about Greece’s determination to cut its budget and overhaul its economy with a requirement that it commit to 89 policy steps¹⁹⁹. It took until a series of fraught meetings in November for Greece to renegotiate the programme terms and make another attempt at getting its debt under control.

Those negotiations slowed the fiscal adjustment pace, providing for more achievable primary surplus targets. The target for 2014, for example, was reduced to 1.5% of GDP from 4.5%²⁰⁰, with a goal of reaching the more challenging target in 2016.

Stournaras said the ‘more realistic’ fiscal targets improved the prospects of turning the economy around. In setting the targets, Greece, the European Commission, and the IMF repeatedly clashed over how far and how fast Greece would need to reduce its spending. The debates would play out repeatedly through the end of Greece’s second programme and, ultimately, to its third rescue in 2015.

Greece had to wait until December 2012 for its next EFSF disbursement. Even when finance ministers signed off on a tranche, they divided it into smaller²⁰¹ sums that would be handed out piecemeal as Greece tackled its demanding to-do list.

The EFSF was always standing by with the money as soon as its release was approved. Thanks to the diversified funding strategy, the firewall no longer had to rush into the markets every time a disbursement loomed. Instead, it could be a more regular and predictable issuer, satisfying investors as well as programme countries.

¹⁹⁹ ‘Eurogroup meeting – October 2012: Press conference – Part 1’, Video, 8 October 2012.

<https://tvnewsroom.consilium.europa.eu/events/eurogroup-meeting-october-2012/press-conference-part-1-210>;

Bloomberg (2012), ‘EU lauds Greek budget-cutting will, boosting aid prospects’, 9 October 2012. <https://www.bloomberg.com/news/articles/2012-10-08/europe-salutes-greek-budget-cutting-will-raising-aid-prospects>

²⁰⁰ European Commission, Directorate-General for Economic and Financial Affairs (2012), ‘The Second Economic Adjustment Programme for Greece first review – December 2012’, *European Economy Occasional Papers* 123, p. 3, December 2012.

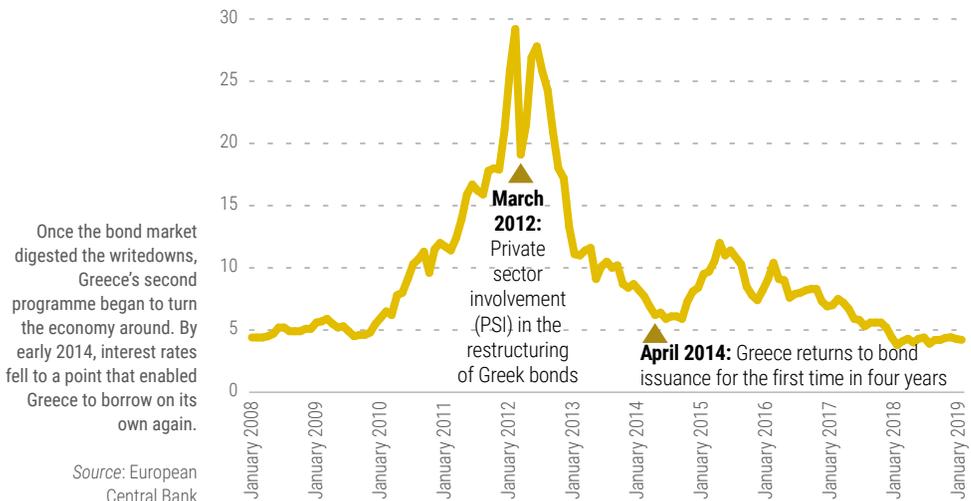
http://ec.europa.eu/economy_finance/publications/occasional_paper/2012/pdf/ocp123_en.pdf

²⁰¹ *Ibid.*, p. 59.

For 2013 and the first half of 2014, the second programme moved along largely as designed. In 2013, the EFSF made eight disbursements to Greece, totalling €25.3 billion, and for a while in 2014, Greece's prospects seemed to be brightening. Full-year GDP growth was 0.7%, turning positive for the first time since 2007²⁰². Ten-year bond yields steadied at around 6% in the summer of 2014. The government made a cautious return to the market on two occasions, and posted a dramatic budget turnaround. Meanwhile, the banks raised private capital and issued bonds. In early 2014, the Commission said Greece had achieved a €1.2 billion primary surplus in 2013 as a result of its fiscal overhaul²⁰³.

10-year government bond yield – Greece

in %, monthly average



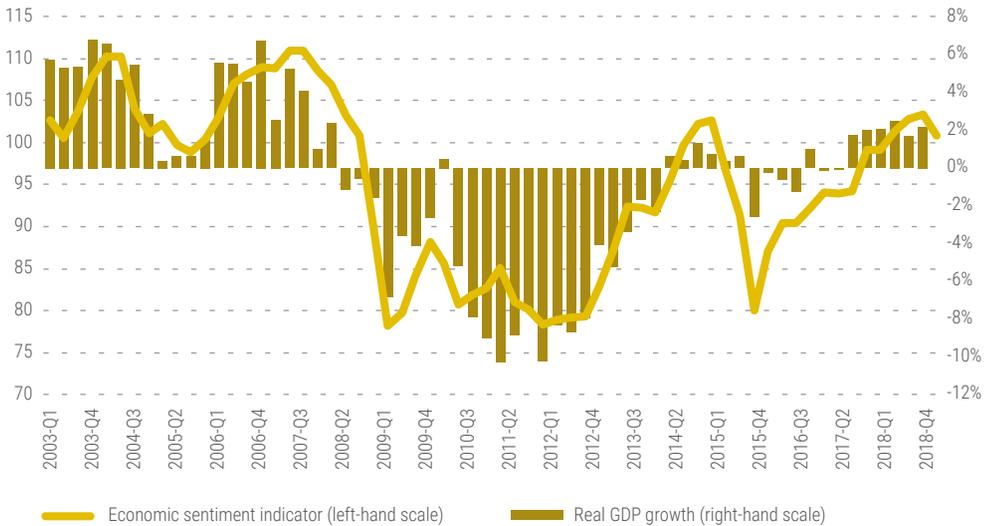
²⁰² Eurostat (n.d.), 'Real GDP growth rate – volume'. <http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=tec00115&plugin=1>

²⁰³ European Commission, Directorate-General for Economic and Financial Affairs (2014), 'The Second Economic Adjustment Programme for Greece – fourth review – April 2014', *European Economy Occasional Papers* 192, p. 14, April 2014. http://ec.europa.eu/economy_finance/publications/occasional_paper/2014/pdf/ocp192_en.pdf

Around mid-2014, Greece seemed to have a chance of wrapping up its programme, as both Ireland and Portugal had done. 'At one point it looked as if they could get out, they could get a credit line, and growth was back,' Strauch said.

Economic sentiment indicator and real GDP growth – Greece

Quarterly frequency



The mood of Greek consumers and businesses mirrored the health of the economy. Hopes in early 2014 that Greece would finally pull out of the crisis proved to be premature.

Note: The long-term average for the economic sentiment indicator is 100.

Source: European Commission and Hellenic Statistical Authority (ELSTAT)

But reform momentum slowed in the second half of the year, as Greece stumbled under the weight of political turmoil and six years of recession. Stournaras became governor of the Greek central bank in June 2014 and was replaced at the finance ministry by Gikas Hardouvelis.

Greece also needed to convince the IMF that its finances were on a sustainable path for at least 12 months, a normal requirement for every IMF disbursement. The IMF had a different approach to debt sustainability from the euro area, but at the time the euro area institutions did not want to break ranks inside the troika. So the review was never concluded, meaning key disbursements didn't take place.

'The biggest error was made in 2014,' said Stournaras. 'It was a big mistake that the review didn't close, on account of a fiscal gap of a few million euros.'

In Stournaras' view, the fiscal shortfall didn't exist, depending on how you ran the numbers. The primary surplus target at the time was 3% of GDP for 2015 and 4.5% for 2016–2017²⁰⁴.

But Rolf Strauch of the ESM recalls that the failure to close hinged as much on the slowdown in structural reforms as on the fiscal gap. 'Towards the second half of 2014, the Samaras government had exhausted its political capital and was basically unable to move forward any significant structural reform. The government had, therefore, fallen behind some benchmarks agreed with the IMF, which were effectively not met. On the European side, the performance gap was smaller, but also not entirely confined to the budget issue.'

Once again, personalities, stress, and emotion influenced the discussions, and ultimately sank any prospect of compromise. Relations were fraying. Some European policymakers felt that Greece rarely delivered on its promises, while many Greek citizens regarded the troika as all but impossible to satisfy. It was a vicious cycle that made the talks even harder at times.

'The game was that they were sceptical about the Greek politicians' ownership of the programmes,' Stournaras said. 'They asked for more and more, thinking that we would implement only a percentage of it. But that was a mistake. Austerity is austerity.' He added: 'The mistake was on both sides. His peers thought that Samaras was bluffing.'

²⁰⁴ European Commission, Directorate-General for Economic and Financial Affairs (2012), 'The Second Economic Adjustment Programme for Greece first review – December 2012', *European Economy Occasional Papers* 123, p. 22, December 2012.
http://ec.europa.eu/economy_finance/publications/occasional_paper/2012/pdf/ocp123_en.pdf

But he was not. The parliamentary group, consisting of members of parliament from two parties, New Democracy and Pasok, supporting the government, could not be convinced that further austerity measures were necessary.’

Towards the end of the year, Samaras felt he no longer had the political backing needed to carry out the last round of budget cuts and structural measures required to secure troika approval. Undercut by faltering support at home, he sought leniency from EU leaders, but they refused to let Greek domestic politics dictate the course of the review. At that point, Samaras saw no choice but to go to the polls.

Strauch said: ‘The last month Samaras was in power, he could no longer push through the kind of significant reforms that we were asking for. That was the stalemate.’

On 8 December 2014, Samaras announced an election for Greece’s largely ceremonial presidency²⁰⁵. Political uncertainty spooked the markets – the day after, the Greek stock market plunged 12.78%, the biggest one-day fall since 1987²⁰⁶. The year closed with political deadlock, as Greece’s parliament failed to choose a new president and Samaras’s government collapsed.

On 25 January 2015, Greece held a parliamentary election²⁰⁷, with Samaras representing both continuity and further belt-tightening, and the Syriza party representing a break with the old and resistance to further spending cuts²⁰⁸. As the clock ran out on the second assistance programme in 2015, Greece and the euro area would face their biggest test yet.

~ Greek programme history, which began in Chapters 3 and 19, continues in Chapters 36, 37, and 38.

²⁰⁵ *Financial Times* (2014), ‘Greek premier calls snap presidential election’, 8 December 2014.

<https://www.ft.com/content/747cdf0c-7f09-11e4-bd75-00144feabd00>

²⁰⁶ *Seeking Alpha* (2014), ‘The Greece stock market: This 12% drop came with a warning’, 9 December 2014. <https://seekingalpha.com/article/2743215-the-greece-stock-market-this-12-percent-drop-came-with-a-warning>

²⁰⁷ *Euronews* (2014), ‘Greek government announces snap presidential vote’, 9 December 2014.

<http://www.euronews.com/2014/12/09/greek-government-announces-snap-presidential-vote>

²⁰⁸ Reuters (2014), ‘Greece faces early election after PM loses vote on president’, 29 December 2014.

<https://uk.reuters.com/article/uk-greece-vote-result/greece-faces-early-election-after-pm-loses-vote-on-president-idUKKBN0K70NH20141229>

Debt sustainability: revising the metrics

23

The structure of Greek debt required a new framework to analyse whether Greek debt would be sustainable in the long run. In that context, flow data are as important in the long run as the traditional debt-to-GDP data.

Klaus Regling

ESM Managing Director and EFSF Chief Executive Officer

Europe's first rescue programmes, from the bilateral loans for Greece to the EFSF-led packages for Ireland and Portugal, were designed to operate in part on the principle of dissuasion, as well as to encourage a smooth programme exit. Short-term lending at elevated rates was intended to spur aid recipients into quickly reinstating sound economic and fiscal policies, so they could return to market financing that would be cheaper than the cost of the rescue loans.

The Greek experience of 2010 and early 2011 led the euro area to consider a different approach to lending terms. A first step came in March 2011²⁰⁹ when the EU agreed²¹⁰ to lower the rates on Greece's

²⁰⁹ Conclusions of the Heads of State or Government of the euro area of 11 March 2011, 11 March 2011. <https://www.consilium.europa.eu/media/21423/20110311-conclusions-of-the-heads-of-state-or-government-of-the-euro-area-of-11-march-2011-en.pdf>

²¹⁰ *The European Council in 2011*, p. 32, January 2012. <http://www.consilium.europa.eu/media/21347/qcao11001enc.pdf>

bilateral loans by 100 basis points and to extend the maturities. In committing to these and other 'more far reaching measures' in July 2011, Euro area leaders also indicated a willingness to ease lending terms to Ireland and Portugal to align with what was now on offer to Greece²¹¹.

At the time, Greece was still paying a 200 basis point surcharge on its first programme. While euro area policymakers discussed more easing of terms, the IMF proposed replacing its stand-by arrangement, which had been put in place alongside the bilateral loans, with a different tool, the extended fund facility, which provides for a longer engagement and repayment period.

'There were two basic options,' said John Lipsky, who served as acting IMF chief in 2011. 'One was to stay with the existing programme, which in any case was going to require additional funding than had been planned initially. As a result, this option meant that those supporting the program were going to have to pay more just to achieve – at best – the original goals. Or, we could move to an extended fund facility in the context of strengthened and lengthened policy commitments. The second option, therefore, meant pay more, but get more.'

The IMF, supported by the European Commission, initially proposed moving to the extended facility deal in mid-2011, before debt restructuring was on the table. The IMF wanted to make the change alongside a funding increase from the euro area and additional reform commitments from Greece, Lipsky said. But, when European finance ministers met in June of that year, the proposal failed. Several of the euro area's smaller countries rejected the plan, even though it had support from bigger member states. 'Without a new agreement, the situation continued to deteriorate to the point that it was clear to all that debt restructuring of some kind had become unavoidable. Thus, there was almost an entire 'lost year' as this new deal was hammered out,' Lipsky said.

The IMF eventually took this step in March 2012 as part of Greece's second programme. Then in November 2012, after lengthy negotiations, euro area finance ministers agreed in principle to a second set of debt relief measures²¹² – a recognition that the initial rescue loans had been too expensive to ensure sustainability.

²¹¹ Statement by the Heads of State or Government of the euro area and EU institutions, Brussels, 21 July 2011. <http://feelingeurope.eu/Pages/euro%20area%20statement%2021-07-2011.pdf>

²¹² Eurogroup statement on Greece, 27 November 2012. https://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/133857.pdf

Known as ‘re-profiling’, the measures covered the first and second aid packages. Loan maturities from both programmes were extended by 15 years. For the bilateral aid in the first programme, the Greek Loan Facility, the interest rate was lowered by a full percentage point and repayment schedules for the loan tranches were extended. For the EFSF loans in the second programme, which already had significantly lower borrowing costs, the Eurogroup agreed to a 10 basis point cut in guarantee fees, along with a 10-year grace period before Greece would have to pay any interest at all on most loans. Finally, the EU Member States also agreed to pass on to Athens profits deriving from Greek bonds held by their national central banks, starting with fiscal year 2013.

In designing these measures, the Eurogroup took care that the changes wouldn’t require a budgetary contribution from member states or hurt the EFSF’s creditworthiness. The euro area also ruled out writedowns of the principal outstanding amount on Greece’s rescue loans. Throughout the discussions on debt relief, the other euro area member states have held firm that Greece must repay its borrowings in full.

Stournaras, who became Greek finance minister in July 2012, commended the firewall team for helping arrange the debt sustainability measures under the November 2012 accord, which also extended the aid period of Greece’s second programme by one year. ‘That was a crucial decision,’ he said. ‘It could not have taken place without the ESM, without an organised team to deal with this issue.’

Taken together, the lower rates and maturity extensions made a big dent in Greece’s debt burden, both improving its immediate public financial outlook and dramatically reducing its long-run costs. At the same time, the member states acknowledged that they might need to do more for Greece, a promise that was to prove increasingly important in the years ahead.

A second round of re-profiling for Ireland and Portugal came up in 2013, when those two countries were again pressing for equal treatment. Greece’s second programme had been overhauled at the end of 2012 and it became clear that the country was once again not on an equal footing with its fellow aid recipients, even though the country was doing a better job than it had been at following through on its reforms.

(From left) Olli Rehn, European commissioner for economic and monetary affairs and the euro, Eurogroup President Jeroen Dijsselbloem, ECB President Mario Draghi, and ESM Managing Director Klaus Regling speak to the media at Dublin Castle, after the Eurogroup agreed on further EFSF maturity extensions for Ireland and Portugal at a meeting on 12 April 2013 in Dublin.

Credit: Peter Muhly/AFP



For Ireland and Portugal, which both had better track records within their programmes as well as substantial financial burdens, the prospect of a second round of re-profiling seemed possible and fair. At first, Greece was viewed as a special case, but gradually the discussion broadened to cover the re-profiling of loans for Ireland and Portugal as well, said ESM Chief Economist Strauch.

Euro crisis managers saw maturity extensions as a way to wean Ireland and Portugal off their programmes and lower the non-repayment risks for European taxpayers. If they lengthened the weighted average maturity, an average of the due dates of multiple loans, the annual burden of servicing debt would decrease and the bottom-line cost of repaying the debt would fall, brightening both countries' public finance pictures.

🔄 For more on budget savings from rescue fund loans, see Chapter 38.

Ireland was already en route to a return to global capital markets, and the new terms helped smooth out its future repayment timeline and plan new bond sales. 'Once our debt was re-profiled, the Irish debt management office had a better window of opportunity to restart their issuance. The extension gave them room to improve their market

presence,’ said Giammarioli, the EFSF’s mission chief for Ireland at the time as well as the head of the rescue fund’s strategy team. Easier debt terms for Portugal also would mark a major step towards regaining market access.

‘For Greece, the decision was to guarantee debt sustainability, while for Portugal and Ireland there were no doubts about debt sustainability,’ Giammarioli said. ‘The political decision at the Eurogroup was not controversial, but the implementation was technically complex.’

Over time, policymakers’ embrace of more flexible conditions for programme countries – in effect, treating them as clients or partners – gained a theoretical underpinning with the debt sustainability framework that ESM Managing Director Regling advocated as the most accurate measure of a country’s ability to repay its loans. The debate gained momentum over the course of 2013, after Greece’s second programme got fully underway at the end of 2012.

‘One should not only look at the level of debt,’ Regling said in a 2013 interview with *the Wall Street Journal*²¹³. ‘One has to look at how it’s financed. And we know today that the EFSF represents the biggest share of Greek public-sector debt and that it will continue to be financed for the next 30 years at very low interest rates. That has to be taken into account, it was not taken into account sufficiently in the past.’

IMF Managing Director Lagarde credits Regling with crafting solutions that were economically sound and politically feasible. ‘The benefit of the ESM’s contribution is to have identified the importance of extending maturities to enhance debt sustainability,’ Lagarde said.

The IMF’s usual method focuses mainly on the debt-to-GDP ratio as an indicator of debt sustainability. Under Regling’s guidance, the euro area has emphasised a different metric that shows Greece’s debt to be on more sustainable footing because favourable EFSF and ESM lending rates and long maturities give it ample room to keep up with its obligations. Under the concept of gross financing needs, made up of interest payments, principal repayments, and the primary deficit, the ESM examines if a country can meet future payments as they come due, rather than if the total stock of debt is too high.

²¹³ *The Wall Street Journal* (2013), ‘Bailout fund boss says current Greek debt analysis “meaningless”’, 26 September 2013. https://blogs.wsj.com/brussels/2013/09/26/bailout-fund-boss-says-current-greek-debt-analysis-meaningless/?mod=article_inline

As far back as 2011, the IMF had been examining alternative ways to gauge repayment prospects, depending on the structure of the debt and the situation of the country. The ESM went further, studying Greece's debt-servicing costs and concluding that Greece's financing trajectory could be sustainable. The ESM's flow analysis lessens concerns about Greece's ability to repay its official sector debt over time.

Prior to Regling's contribution, the IMF had concluded that Greece's debt was perhaps too large given the size of its economy, and it pushed the euro area to consider an official sector writedown. But such a move would be at odds with the currency area's consistent philosophy and the EU Treaty's no-bailout rule. Looking at Greece's payment outlook, instead of its debt-to-GDP ratio, allows the EU to bolster its case for requiring all official sector loans to be repaid in full.

To be sure, the IMF also factors gross financing needs into its computation of debt sustainability, subjecting countries that overstep a critical threshold to closer scrutiny. But IMF loans are much shorter than the ESM's, rarely exceeding 10 years, and the Washington-based lender puts more weight on overall debt-to-GDP ratio to assess repayment ability.

The difference from the ESM is one of emphasis. Regling put the spotlight squarely on gross financing needs, especially for Greece, because the rescue fund provided large sums with very long maturities and low interest rates. It will be decades before a large part of the Greek debt comes due. So, although the level of debt has not changed, Greece's repayments are spread over a lengthy span of time and it will not need to start principal repayments – the outflows that will make up the largest component of its financing needs – for many years. Thus the ESM methodology shows that Greece's debt trajectory is more sustainable than some of the more pessimistic models would suggest²¹⁴. During and after Greece's third programme, when debt relief would be a central part of the policy agenda, this metric would be more important than ever.

Regling made the case 'very forcefully and effectively' for using a different metric for Greece, Lipsky said. 'Klaus made the right points and I think won the argument.'

²¹⁴ Gabriele, C., Erce, A., Athanasopoulou, M., and Rojas, J. (2017), *Debt stocks meet gross financing needs: A flow perspective into sustainability*, ESM Working Papers 24, 14 June 2017. <https://www.esm.europa.eu/publications/debt-stocks-meet-gross-financing-needs-flow-perspective-sustainability>

Breaking the doom loop: towards banking union

24

An important early step was the summer 2012 decision for a banking union. At that time there was all this talk about European banks bringing down European governments, and whether that would mean the end of Europe.

Andres Sutt

Former ESM Head of Banking

In the spring of 2012, Spain too was suffering from downgrades as it struggled to get its banking system under control. The banking crisis would soon force the Spanish government, under its Prime Minister Mariano Rajoy, to seek euro area aid. Yet Spain was far from alone in its concern about the financial sector. Countries across the euro area feared some of the biggest banks could collapse, bringing down sovereigns and the common currency with them.

This phase of the euro crisis reshaped the political map of Europe, eventually helping spearhead a drive to address the sovereign-bank nexus, which was seen as one of the biggest threats to financial stability²¹⁵. Creating tools to break that so-called ‘doom loop’ seemed

²¹⁵ For an analysis of the correlation between bank and sovereign risk, see Erce, A. (2015), *Bank and sovereign risk feedback loops*, ESM Working Papers 1, 7 September 2015.

<https://www.esm.europa.eu/publications/bank-and-sovereign-risk-feedback-loops>

a logical method of defence. There would also be a move to end the fragmentation of financial markets within the currency union by creating a common EU supervisor and a bank resolution regime.

IMF chief Lagarde was among first financial leaders to call for a European banking union. The euro area already had a central bank, but the continent-wide industry lacked coordinated supervision to prevent banks from taking on too much risk, and it did not have comprehensive deposit insurance that could help prevent a bank run.

Unlike in the US, where the Federal Deposit Insurance Corporation had been set up in 1933 in response to the Great Depression, there was little precedent on the EU level for how to handle a failing private lender. Generally speaking, few avenues other than state support shielded consumers and investors from the consequences of a bank failure.

When the euro was launched, banking supervision was the sole preserve of individual member states. As it became clear that a problem in one country could imperil everyone, however, policymakers began to believe that any bank big enough to pose a systemic threat to the euro area should be supervised at that level.

In a 17 April 2012 speech, Lagarde noted that the fragmentation of financial markets had been created by a patchwork of financial regulation and oversight that left the common currency struggling to preserve financial stability. She pointed to the growing worry of a vicious cycle between banks and sovereign nations, where the misfortunes of one could topple the prospects of the other. Europe had seen this work both ways: the banking sector's problems damaged Ireland's overall economy, whereas Greece's banks, heavily invested in their sovereign's domestic debt, were harmed by the Greek public debt crisis and its impact on the broader economy.

'To break the feedback loop between sovereigns and banks, we need more risk sharing across borders in the banking system. In the near term, a pan-euro area facility that has the capacity to take direct stakes in banks would help,' Lagarde said. 'Looking further ahead, monetary union needs to be supported by stronger financial integration which our analysis suggests be in the form of unified supervision, a single bank resolution authority with a common backstop, and a single deposit insurance fund'²¹⁶.

²¹⁶ IMF (2012), 'IMF/CFP policy roundtable on the future of financial regulation', Opening remarks by Christine Lagarde, 17 April 2012. <http://www.imf.org/en/News/Articles/2015/09/28/04/53/sp041712>

Changes in Europe's political constellation would put together a coalition to tackle banking problems. In May 2012, voters in France replaced President Sarkozy, who had shaped the crisis response alongside Germany's Chancellor Merkel, with the socialist François Hollande.

Ahead of a Group of 20 summit in June 2012, there were increased calls for the euro area to do more to help countries such as Italy weather the crisis and steer clear of potentially crippling contagion. When leaders met on 18 and 19 June in Los Cabos, Mexico, the euro area was urged to shore up its financial foundations.

'We fully support the actions of the Euro Area in moving forward with the completion of the Economic and Monetary Union,' their statement said. 'Towards that end, we support the intention to consider concrete steps towards a more integrated financial architecture, encompassing banking supervision, resolution and recapitalization, and deposit insurance'²¹⁷.

In the run-up to the 29 June 2012 European summit, tension mounted over whether or not the EFSF – or the ESM, then a few months from its inauguration – should be called into action to buy bonds of countries where market access appeared to be tenuous. While the purchasing tools existed, there was no consensus on whether to activate them.

A former European commissioner, Mario Monti, had become Italy's prime minister in mid-November 2011, bringing with him a pro-European mindset and a government committed to reforms. The economics professor was trusted as a safe pair of hands by other European leaders – and crucially by financial markets.

In Monti's view, Europe had to stand for something positive lest market turbulence destroy confidence in the entire euro project. His support would be pivotal for the emerging concept of banking union within the monetary alliance.

Italy's Monti, joined by France's Hollande and Spain's Rajoy, rallied support for more help.

Euro area leaders eventually zeroed in on financial infrastructure as the area where they could make the most impact. They directed their finance ministers to develop a strategy to help troubled banks directly without burdening the balance sheet of any already struggling country²¹⁸.

²¹⁷ Group of 20 (G20) (2012), 'G20 leaders declaration', 18 and 19 June 2012.

<http://www.g20.utoronto.ca/2012/2012-0619-loscabos.pdf>

²¹⁸ For an analysis of the regulatory treatment of sovereign debt held by banks, see Lenarčič, A., Mevis, D., Siklós, D. (2016), *Tackling sovereign risk in European banks*, ESM, Discussion Paper 1, 1 March 2016.

<https://www.esm.europa.eu/publications/tackling-sovereign-risk-european-banks>

In a 29 June summit statement²¹⁹, the leaders laid the foundation for what would become the euro area banking union, envisaging a move to common supervision and resolution powers alongside harmonisation of national deposit insurance laws. The banking union would be mandatory for members of the common currency and open to any other EU countries wishing to join. Euro area leaders also pledged to use the ESM to help banks directly as necessary to protect financial stability.

This June 2012 commitment to banking union was a major breakthrough for Europe. The commitment to joint financial sector safeguards allowed the currency union to move forward.

Banking union has three main elements: supervision, resolution, and deposit insurance²²⁰. The first element aims to keep banks from getting into trouble by making sure a European regulator monitors day-to-day affairs. The second is designed to make sure that EU-wide there is a safe way to restructure or shut down a failing bank, avoiding a chaotic collapse that could spawn contagion. And the third element focuses on protecting the broader economy by reassuring savers that the banking system is safe and that they can access their insured cash – up to €100,000 – even if a bank falls on hard times²²¹. This can prevent national bank runs.

Using a section of the EU Treaty that allows the ECB to take on new powers, the leaders called on the European Commission to draft a proposal for a single supervisory body. This was a major success for those favouring greater integration throughout the euro area, as it made it possible to create a joint banking supervisor.

The political breakthrough led the euro area to create a new regulator, housed at the ECB: the Single Supervisory Mechanism, which became operational in November 2014²²². It has direct oversight of about 120 systemic banks across the bloc²²³ – the three biggest banks in every country, plus others that operate across borders or meet certain thresholds and are also considered systemic.

²¹⁹ Euro area summit statement, 29 June 2012.

<https://www.consilium.europa.eu/media/21400/20120629-euro-area-summit-statement-en.pdf>

²²⁰ European Commission (n.d.), 'Banking union'.

https://ec.europa.eu/info/business-economy-euro/banking-and-finance/banking-union_en

²²¹ European Commission (n.d.), 'Deposit guarantee schemes'.

https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-supervision-and-risk-management/managing-risks-banks-and-financial-institutions/deposit-guarantee-schemes_en

²²² Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institution, OJ L 287/63, 29 October 2013.

<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R1024&from=en>

²²³ ECB, Banking supervision (n.d.), 'Single Supervisory Mechanism'.

<https://www.bankingsupervision.europa.eu/about/thessm/html/index.en.html>;

Single Supervisory Mechanism (n.d.),

<https://www.consilium.europa.eu/en/policies/banking-union/single-supervisory-mechanism/>

The euro area also adopted a Single Resolution Mechanism for banks under ECB oversight²²⁴. Euro area member states backed this up by asking banks to begin paying into an accompanying Single Resolution Fund and build it up to its target of 1% of the deposits of the banks in the participating countries, initially estimated at €55 billion²²⁵. This fund is ramping up over eight years from 2016 to 2023, with the full capacity to be reached in 2024.

There was some initial talk of housing the resolution agency and its fund at the ESM, but euro area leaders decided against making the soon-to-debut ESM fully responsible for salvaging banking sectors weighed down by legacy issues. Meanwhile, the ESM had been tasked with developing a tool for recapitalising banks directly.

The EU made tremendous strides on the supervisory and resolution fronts between 2012 and 2014, while the ESM was developing its direct bank recapitalisation capability.

🌀 For more on the direct recapitalisation instrument, see Chapter 34.

Although that instrument was never deployed, Andres Sutt, then ESM head of banking, called it an important part of the arsenal. ‘It’s better to have the option in your toolkit than not have it at all,’ Sutt said. ‘If things get really bad, then you have something at hand to use.’

Another European priority during this period was to draw up a legal framework for dealing with troubled banks, setting out a clear hierarchy for assigning losses to different classes of investors. The landmark bank recovery and resolution directive was set up to govern the treatment of failing banks. It requires banks to create recovery and resolution plans ahead of time and began taking effect at the end of 2014²²⁶. These rules, which apply to the entire EU, not just the euro area, changed the parameters for the ESM bank recapitalisation instrument even as it was being developed.

The core principle of the directive is that bank creditors such as shareholders and bondholders must bear losses before any public support can be drawn upon. This reflected a standardising and

²²⁴ European Commission (n.d.), ‘Single resolution mechanism’: https://ec.europa.eu/info/business-economy-euro/banking-and-finance/banking-union/single-resolution-mechanism_en

²²⁵ Single Resolution Board (n.d.), ‘What is the Single Resolution Fund?’: <https://srb.europa.eu/en/content/single-resolution-fund>

²²⁶ European Commission (2014), ‘EU bank recovery and resolution directive (BRRD): Frequently asked questions’, 15 April 2014. http://europa.eu/rapid/press-release_MEMO-14-297_en.htm

toughening of previous EU approaches on public aid to banks, which limited state aid under EU competition law but didn't dictate losses in such a specific way.

In Ireland and Spain, for example, the question of whether or not and how to force senior bank creditors to take losses became an integral part of the debate around their rescue programmes. At one point early on, Ireland had wanted to 'bail in' – or impose losses upon – senior bank bondholders as well as junior investors, only to be dissuaded by its fellow euro area member states. At that time, there was a view that pushing bank bonds into default could further escalate the crisis.

By the time it became apparent that Spanish banks would need recapitalising, consensus was building around the idea that junior creditors, at least, should always absorb losses before taxpayer funds were put at risk. But the idea was still controversial, particularly because in some countries bank bonds were marketed to consumers as equivalent to cash savings accounts, even though they posed greater risks.

The bank recovery and resolution directive aimed to make clear to investors up front what risks they were taking. It became an essential part of the long-term effort to strengthen the euro and its financial architecture. In a move to limit the tapping of taxpayer funds, the directive also required the banking industry to fund the cost of resolution wherever possible. To accomplish this, every EU Member State was required to set up a bank resolution fund financed by industry fees. Some countries already had a system in place, while others had a deposit insurance scheme to coordinate with. Even after the euro area created a common resolution system for the currency area's biggest banks, countries also continued to need national systems for banks not covered by regular ECB supervision.

Since 2016, the euro area has had common systems for two elements in banking union, supervision and resolution²²⁷, and it is establishing rules on national frameworks for the third, deposit insurance²²⁸. Proposals for a common deposit insurance system, which would complete the banking union fully, may take time before they are ripe for agreement, given important legacy problems with banks in several member states and sizeable non-performing loan problems in some countries.

²²⁷ Single Resolution Board (n.d.), 'About SRB'. <https://srb.europa.eu/en/mission>

²²⁸ European Commission (n.d.), 'Deposit guarantee schemes'. https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-supervision-and-risk-management/managing-risks-banks-and-financial-institutions/deposit-guarantee-schemes_en

Spain's banks: the ESM's first programme

25

We carried out reforms essential to our economy in record time, and despite enormous pressure. They laid the foundation for our economic recovery.

Luis de Guindos

Spanish Minister of Economy, Industry, and Competitiveness
(December 2011–March 2018)

Spain's crisis was a boom-bust cycle turned explosive by euro area contagion. In the 2000s, the Spanish economy was generally flourishing, its growth outpaced its European neighbours, and the budget recorded a solid surplus in many years. Most job seekers could find work, aided by a construction boom. Easy loans from banks fed a bubble, as house prices nearly tripled between 1997 and 2008.

When the credit crunch hit, real estate prices collapsed. Clients, particularly real estate and construction companies, struggled to repay loans and banks were left with huge losses.

1999

1 January

Spain adopts the euro.

2008

Economy enters recession as a decade-long property and credit bubble bursts. Unemployment and fiscal deficit increase significantly.

2009

19 January

Standard & Poor's downgrade: AA+ from AAA, the first in a series by the major rating agencies, although Spain never loses investment grade.

26 June

Fund for Orderly Bank Restructuring (FROB) is established, to channel public financial support to banks.

2010

April-May

Financial markets focus on large fiscal deficit. Government announces consolidation measures.

2011

21 December

Mariano Rajoy becomes the new Spanish prime minister, following elections on 20 November.

2012

27 January

Jobless rate for 2011 jumps to 22.9%, or 5.27 million people – then the highest in the EU. The rate will peak at an average 26.2% in 2013, surpassed only by Greece's 27.5% during the crisis.

30 March

Government proposes a drastic reduction in budget spending of 16.9%, or €27 billion, after a 2011 fiscal deficit first estimated at 8.5% of GDP, but later revised to 9.6%.

25 April

IMF identifies a group of 10 banks that are vulnerable, including the country's largest mortgage lender, Bankia.

9 May

Central bank confirms Bankia is to be partly nationalised.

25 June

Formal request is made for assistance.

20 July

Eurogroup approves Spanish programme for the recapitalisation of financial institutions, covering financing needs of up to €100 billion.

16 November

Spain's FROB issues blueprint for Sareb as a 'bad bank.'

28 November

European Commission approves state aid and restructuring plans for several key banks.

11 December

ESM disburses first loan tranche (€39.5 billion).

2013**5 February**

ESM disburses second and final loan tranche (€1.87 billion).

31 December

Spain successfully exits ESM financial assistance programme.

By 2009, Spain was in recession. As the economy contracted, high unemployment and debt levels added to the real estate woes. Growth improved a little in 2011, but, by the end of that year, almost one in four Spanish workers couldn't find a job. Spain was home to the highest unemployment in the EU that year. The rate kept rising, peaking in 2013 at an annual average of 26.2%, or six million unemployed. By then, Greece had taken over as the country with the bloc's worst-performing labour market, with a jobless rate of 27.7%²²⁹.

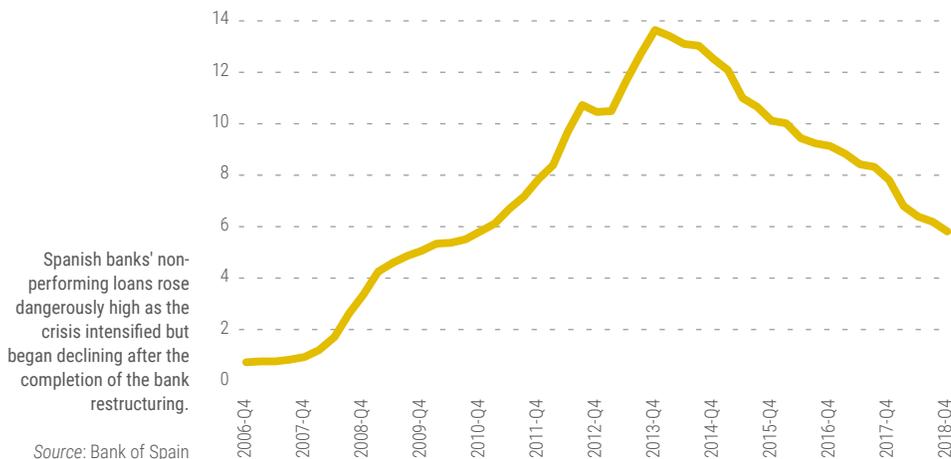
'Spain faced the combination of a loss of competitiveness, a credit bubble, and a housing bubble. After the outbreak of the international financial crisis, these imbalances led Spain into a triple crisis: banking, fiscal, and labour,' said Luis de Guindos, who joined Rajoy's government as economy minister after elections in late 2011.

As Spain fell back into recession at the start of 2012, the euro area threatened to disintegrate around it. Greece was still struggling. Ireland's and Portugal's government bond prices had fallen and yields soared in the summer of 2011. Both countries faced downgrades from the various rating agencies, and other countries confronted market strain as well.

²²⁹ Eurostat (n.d.), 'Employment and unemployment (Labour force survey)'.
<https://ec.europa.eu/eurostat/web/lfs/data/database>

Non-performing loans – Spain

as % of outstanding bank credit, quarterly frequency



Spain was under enormous pressure to get its finances under control quickly. De Guindos said the rest of the euro area began to see Spain as a concern, encapsulated by a chance encounter at a gathering of finance ministers.

‘The story I remember best, largely because of its media impact, was a practical joke that Jean-Claude Juncker – who then chaired the Eurogroup – played on me in March 2012,’ de Guindos said. ‘Juncker approached me, without my seeing him, at the start of a Eurogroup when the cameras were still in the room. He put both hands around my neck, pretending to strangle me.’ De Guindos continued: ‘First I was shocked, but I quickly understood it was a joke, laughed, and the grip ended in a hug. The image appeared everywhere in the media because it symbolised perfectly the situation we were in. Europe did not trust Spain after the deficit mushroomed, and wanted to tighten the screws on us to ensure that we reduced it at a faster pace than we could manage.’



Eurogroup President Jean-Claude Juncker puts a joking 'stranglehold' – that quickly transformed into a hug – on Spanish Economy Minister Luis de Guindos at a March 2012 Brussels meeting.

Credit: Isopix/Rex Features/Shutterstock

Spain passed a budget law that enacted big cuts of nearly 16.9%, or €27 billion, in March, as it attempted to rein in a public deficit that was first put at 8.5% of GDP in 2011 and later revised to 9.6%²³⁰. But the banking problems would prove too difficult for Spain to resolve on its own. In April 2012, the IMF said the past four years had seen 'a crisis of unprecedented proportion in the Spanish financial sector'²³¹.

²³⁰ Spain, Prime Minister's Office (2012), 'El Gobierno aprueba el Proyecto de Ley de Presupuestos para 2012' (Government approves the 2012 Budget bill (ESM translation)), 30 March 2012. <http://www.lamocloa.gob.es/consejodeministros/resumenes/Paginas/2012/300312-consejo.aspx>; Reuters (2012), 'Spain reveals deep cuts to meet deficit goal', 1 April 2012. <https://uk.reuters.com/article/uk-spain-cuts/spain-reveals-deep-cuts-to-meet-deficit-goal-idUKBRE82T0OD20120401>

²³¹ IMF (2012), 'Spain: financial sector assessment, preliminary conclusions by the staff of the International Monetary Fund', Online statement, 25 April 2012. <https://www.imf.org/en/News/Articles/2015/09/28/04/52/mcs042512>

General government fiscal balance – Spain

in % of GDP



With further pummelling from global shocks, the banking crisis now threatened the entire Spanish economy. Even though Spain's biggest banks were deemed well capitalised, the IMF warned that a group of 10 struggling lenders could topple financial stability if not addressed. Furthermore, in its June 2012 financial stability assessment report on Spain, the IMF's team pointed to vulnerabilities, with 'the risk of an even more severe downside shock than embodied in the analysis'²³².

Banks were not doing enough to make sure their clients could pay back their loans. At the time, banks – not just in Spain but also in many European countries – did not report the amount of underperforming loans in their financial reports, which undermined market confidence in the banks' stated health. Right before the IMF report, several Spanish banks faced credit-rating downgrades, some reaching junk status, and Spain's previous repair efforts began to fall apart.

'Despite the reform marathon, I realised that we were going to have to ask for help when we began to see, in the first days of May 2012, the real situation of the banks and, in particular, of Bankia, which had to be nationalised,' de Guindos said.

²³² IMF (2012), 'Spain: Financial stability assessment', IMF country report No. 12/137, June 2012. <https://www.imf.org/external/pubs/ft/scr/2012/cr12137.pdf#page=7>

Bankia had been founded in 2010 from a group of seven struggling savings banks to become Spain's largest real estate lender and, overall, one of the largest banks in the country. When it had to be completely taken over by the state, the Spanish government's stake was converted to voting equity. Bankia also became a test case for the way bank bondholders were treated across Europe. Under EU rules, for Spain to be allowed to pump more aid into the bank, it would need to figure out how bank bondholders would help share the burden.

Confidence was faltering. Some €300 billion in foreign capital fled the country over the year from the third quarter of 2011 to the third quarter of 2012, largely as a drain on the balance sheets of the financial sector. Spain needed to win back market credibility – and fast.

Spain's access to markets had become more limited, with the risk that it wouldn't be able to borrow enough on its own, de Guindos said. 'We needed a solution that would prevent the damage that the housing and credit bubble had caused financial institutions from affecting the public treasury.'

Cristóbal Montoro, the Treasury minister, laid bare the situation on 5 June: 'The risk premium says Spain doesn't have the market door open. The risk premium says that as a state we have a problem in accessing markets, when we need to refinance our debt'²³³. Four days later, the Eurogroup indicated it would respond favourably to a formal request for assistance.

Despite the Spanish government's efforts to cut the budget and rein in the banks, more was needed. 'Before requesting assistance, Spain tried to solve the problem by consensus,' said Juan Rojas, a former Bank of Spain economist who now heads the ESM's economic and market analysis team. 'They tried to change several laws to make the banking sector more resilient, but the uncertainty regarding the quantity of bad loans in the banking sector was so huge that the market did not believe in the process. That is why, in the end, Spain had to come to the ESM.'

On 25 June, Spain requested a programme for its banks²³⁴. The yield on Spain's 10-year government bond averaged a painful 6.6% that month,

²³³ Reuters (2012), 'Spain says markets closing on it, seeks help for banks', 5 June 2012. <https://www.reuters.com/article/us-eurozone-idUSBRE8530RL20120605>

²³⁴ Spain, Prime Minister's Office (2012), 'Spain formally requests financial aid for Spanish banks', 25 June 2012. http://www.lamoncloa.gob.es/lang/en/gobierno/news/Paginas/2012/20120625_RequestAidBanks.aspx

an expensive rate at which euro area sovereigns typically no longer issue. Cyprus requested a programme on the same day, although its programme would take much longer to negotiate and would include a full macroeconomic assistance package.

Spain was the first, and so far the only, euro area member state to request a rescue programme only for the financial sector. One of the euro area's largest economies, it didn't require a full macroeconomic adjustment programme because of reforms implemented earlier and because it was still able to borrow on capital markets. By limiting the aid programme to the financial sector, Spain could focus on 'the root of the problem,' Rojas said.

Euro area leaders reacted positively. On 29 June, they urged rapid completion of the aid deal. And on 20 July the Eurogroup approved it and bond yields started to drop. The Eurogroup granted Spain a financing envelope of up to €100 billion, although the precise amount would be determined after a more detailed assessment of the banks' capital needs²³⁵. Three days later, the EFSF Board of Directors approved the assistance. The EFSF was fully prepared to act and pre-funded €30 billion in notes that could have been deployed if needed, although the money was never used in the interim period between Spain's request and the start of the ESM.

As Spain prepared for the ESM programme, the capital outflows came to an end²³⁶. 'I must underscore that, although markets, some of the press, and foreign and Spanish businesses pushed us to ask for a full programme, this was never on the table,' de Guindos said. 'As doubts were highly concentrated in the financial sector, it was best to tackle the fire with a programme limited to banking.'

²³⁵ Statement by the Eurogroup, 20 July 2012.

http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/131914.pdf

²³⁶ *The Telegraph* (2012), 'IMF fears "credit shock" in Spain if Rajoy blocks rescue', 10 October 2012. <https://www.telegraph.co.uk/finance/financialcrisis/9600476/IMF-fears-credit-shock-in-Spain-if-Rajoy-blocks-rescue.html>

Its financial adjustment programme was intended solely for indirect bank recapitalisation, meaning the ESM would lend to the Spanish government for the sole purpose of restructuring the banking sector. Nonetheless, the Spanish knew they would need to assuage markets by having access to enough money to quash any doubts. 'In previous negotiations, it had become obvious that we had to ask for a sufficiently excessive amount to send the message that, no matter how big the problem, we were covered,' de Guindos said.

From a technical standpoint, Spain had initially signed a deal with the EFSF because, at the time, the ESM was not expected to begin operations in October. The ESM took over the programme in November 2012, just before Spain negotiated its first instalment. That made Spain the first client of the permanent firewall. The role of the IMF had to be limited, as it does not provide any loans to specific sectors such as banking. Instead, the IMF took part in an advisory capacity, without offering Spain any money. Or as IMF chief Lagarde said: 'We participated in Spain but as a monitor.'

Before euro area bank supervision began in 2014 and the Single Supervisory Mechanism began conducting regular comprehensive assessments of the big banks that came under its care, European authorities were reviewing the Spanish financial sector to determine the level of need. However, given market concerns about banks' financial reporting, and the May 2012 partial nationalisation of Bankia, Spanish authorities thought they needed to take matters one step further in assuaging any fears about forthrightness.

'At the time there was considerable speculation about the situation of Spanish banks, with erroneous figures floating about. These doubts could only be cleared up with a fully transparent exercise. So we commissioned an independent evaluation,' de Guindos said.

Spain retained the consultancy firm Oliver Wyman to conduct an independent and comprehensive review of Spanish banks. In September 2012, the report²³⁷ identified a group of Spanish banks,

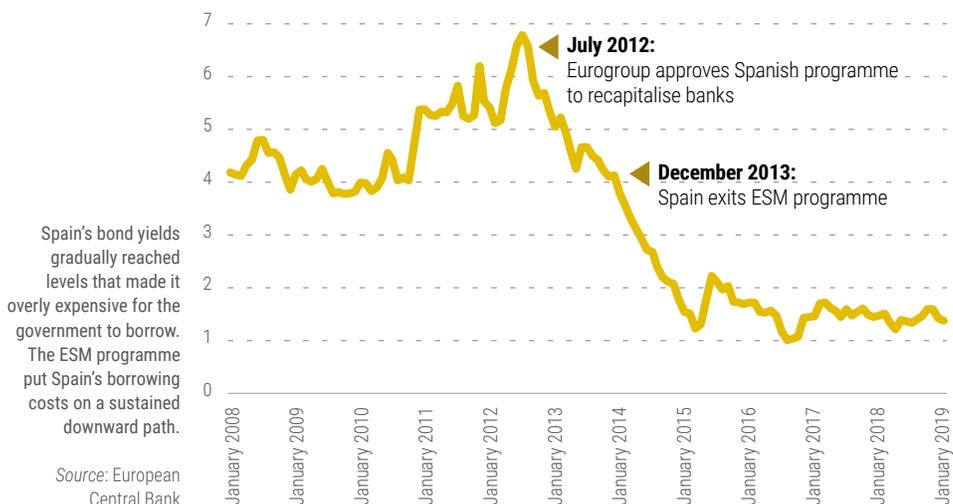
²³⁷ Oliver Wyman (2012), 'Asset quality review and bottom-up stress test exercise', Oliver Wyman, Madrid, 28 September 2012.
https://www.bde.es/f/webbde/SSICOM/20120928/informe_ow280912e.pdf

including the mortgage-lending giant Bankia, that would need significant additional capital. In the short run, this contributed to another downgrade²³⁸.

The Eurogroup tied Spain's assistance to a set of conditions for the financial sector. Under the programme, Spain would improve the way it regulated and supervised its banks, figure out a new approach to the bad loans clogging up balance sheets, and put together in-depth bank restructuring plans. The overhauls would be designed in cooperation with the European Commission's Directorate-General for Competition, to make sure they were in line with EU state aid rules.

10-year government bond yield – Spain

in %, monthly average



Spain attempted to anticipate the rescue programme's conditions by pledging to meet its EU-set budget goals and by amending its banking laws to match the euro area requirements. De Guindos said the main accomplishments were 'making the savings banks – which had

²³⁸ Spain, Prime Minister's Office (2012), 'Oliver Wyman estimates the Spanish banking system's capital needs at close to €60 billion', 28 September 2012. http://www.lamoncloa.gob.es/lang/en/gobierno/news/Paginas/2012/20120928_Spanishbanking.aspx; Spain, Central Bank of Spain (2012), 'Cost of the Spanish banking sector solvency tests', Press release, 31 October 2012. https://www.bde.es/f/webbde/GAP/Secciones/SalaPrensa/NotasInformativas/12/Arc/Fic/presbe2012_48e.pdf

been in trouble for some time – disappear and improving corporate governance,' along with creating a Spanish bank recapitalisation fund. Set up in 2009, the Fund for Orderly Bank Restructuring, commonly known as the FROB from its Spanish acronym, would make the resolution process for Spanish banks more uniform and transparent²³⁹.

There was also a 'bad bank' tasked with taking troubled loans off bank balance sheets and pushing for repayments. Called Sareb, from its Spanish acronym, it is a private sector entity put together as part of Spain's euro area aid programme. It received about 200,000 bad loans and foreclosed properties, totalling about €51 billion, from banks that had been nationalised and restructured as part of the programme²⁴⁰.

Another potential difficulty emerged. Under treaty rules, the ESM enjoys preferred creditor treatment over other bondholders. While markets had accepted that Greece had to impose haircuts on its private sector bondholders, they were skittish about how quickly that precedent could extend to the rest of the euro area. In the case of Spain, they began to question if it meant the country's overall credit risk was worse than the euro area was admitting to. This was the last thing Spain – which was not completely shut out of financial markets – needed.

As the financial assistance for Spain was originally to be provided by the EFSE, the Eurogroup decided that the ESM assistance programme would maintain the status of EFSE loans, whose debt was on an equal footing with that of other creditors, rather than follow the preferred creditor status of ESM loans²⁴¹.

The FROB also would have to decide which bank creditors should share the burden of recapitalising the banks, one of the conditions set out by the rescue agreement. This was controversial both because of the lack of precedent and because of the way bank debt had become embedded in the overall economy. Ordinary households had sunk their savings into bank bonds that were far riskier than promised, and one of the FROB's challenges would be figuring out how to

²³⁹ Spain, Minister of Economy and Finance (2009), 'Minister of Economy and Finance order issuing guarantee of the Central Government (Administración General del Estado) to secure obligations to the Fund for Ordered Banking Restructuring arising from issues of financial instruments, the arrangement of loan and credit transactions, and the execution of any other financing transactions by that fund, in accordance with the provisions of Royal Decree-Law 9/2009, of June 26, on bank restructuring and reinforcement of credit institutions' own funds', Partial transcript. http://www.frob.es/en/Documents/Extracto_orden_otorgamiento_Aval_FROB_prot_En.pdf

²⁴⁰ Sareb (n.d.), 'About us'. https://www.sareb.es/en_US/about-us

²⁴¹ ESM (2014), 'Frequently asked questions on the European Stability Mechanism (ESM)', Factsheet, 28 July 2014. <https://www.esm.europa.eu/sites/default/files/faqontheesm.pdf>

protect these individuals while also treating all creditors fairly in the writedown process. In the end, the FROB chose to impose losses on junior creditors while protecting senior creditors, and it later carried out a domestic programme to compensate ordinary households that had lost savings in the process.

To keep the banks safely open and avoid a run on the banks, almost all of the necessary recapitalisation funds from the ESM were disbursed in one go. This required some creative thinking from the funding team, which resorted to a cashless system of floating rate notes and zero coupon bills.

~ For more on this funding approach, see 'Focus – When bonds are better than cash' later in this chapter.

Technical procedures surrounding programme implementation gave some reassurance that Spain would stay on a solid footing even after the disbursements, ESM Chief Economist Strauch said. For example, the Commission required Spain to show its business plan for the sector before financial assistance could be released. The Commission approved the state aid plan on 28 November²⁴², allowing the first disbursement of just over €39 billion to go forward less than two weeks later in December 2012, followed by a second, far smaller, disbursement in February 2013²⁴³.

'Only then, once everything is cleared and the European Commission's decision is taken, do we ship any type of capital, which is much sounder and has now become the general approach,' Strauch said. 'Overall, this was skilfully handled, on the Spanish side and from an overall programme management perspective.'

In the end, Spain used only around €41 billion for the banking sector out of the total potential €100 billion. The rescue programme was a true firewall, giving Spain the time and security to put its economy back on track. 'We believed that with the rescue of the banks in general,

²⁴² European Commission (2012), 'State aid: Commission approves restructuring plans of Spanish banks BFA/Bankia, NCG Banco, Catalunya Banc and Banco de Valencia', Press release, 28 November 2012. http://europa.eu/rapid/press-release_IP-12-1277_en.htm

²⁴³ ESM (n.d.), 'Financial assistance for the recapitalisation of the Spanish banking sector'. <https://www.esm.europa.eu/assistance/spain>

and of Bankia in particular, the situation would improve, and that was indeed the case,' de Guindos said.

In de Guindos' view, although contagion was real, markets overreacted to Spain's difficulties. They were uncertain about the solvency of the financial system and how this would affect sovereign debt, meaning Spain was seen as a bellwether for the entire common currency. 'In part, the markets attacked the euro through Spain, because they perceived it as the weak link and, in part, because their view of our economy was worse than reality,' de Guindos said.

Spain's programme was short – only 18 months. It probably helped that it was more focused than the other programmes.

Spanish programme (2012–2013)



Initial programme amount: €100 billion



Total amount disbursed: €41.3 billion



Lenders: ESM



Final weighted average maturity: 12.5 years



Key legislated reforms: asset quality review of the banking sector and stress test; recapitalising and restructuring weak banks; transfer of problem assets to an external asset management company; bank governance rules

After Spain exited its programme in December 2013, the reforms undertaken helped spark a surge in economic growth.

'The restructuring of the financial sector also interacted with other reforms, such as labour, energy, the single market, budgetary stability, and trade liberalisation. This, together with efforts to reduce the deficit, is what is driving Spanish growth – currently at twice the euro zone average,' de Guindos said in 2016.

Spain underlined this better performance by voluntarily starting to repay its ESM loans in 2014, earlier than required. By October 2018, it had made nine voluntary repayments, paying off 42.6% of the total outstanding amount of the €41.3 billion ESM loan to Spain and leaving it at €23.69 billion.

In its 2017 review of the Spanish economy, the Organisation for Economic Co-operation and Development said: ‘The Spanish economy is enjoying a robust recovery from a deep recession, with structural reforms contributing to high growth rates and a gradual decline in unemployment.’ It added that ‘further measures are needed to boost productivity and to ensure that the benefits of growth reach all Spaniards’²⁴⁴.

Focus

When bonds are better than cash

When the firewall provides countries with financial aid to recapitalise their banks, it puts a different kind of financing strain on the ESM from regular rescue loans. To keep banks open and avoid a bank run, bank recapitalisation – whether through a bank-only programme such as Spain’s, or as part of a wider programme as was the case for Greece and Cyprus – often needs to happen all at once. But, as anyone who has needed to raise cash in a hurry knows, market interest rates can sometimes be punitive.

An EFSF and ESM innovation to get around this was to use floating rate notes instead of cash for the disbursement of the loan. Those bonds, which have a variable interest rate, are sold to one of the 40-odd international banks that belong to the ESM Market Group, in a process needed to legally create the notes, and then the ESM immediately repurchases the notes after the bank subscribes. No gains or losses are linked to either transaction, both of which occur on the same day and for the same price. The ESM then holds the notes

²⁴⁴ OECD (2017), ‘Spain: Maintain reform momentum to enhance economic recovery and boost inclusive growth’, Press release, 14 March 2017. <http://www.oecd.org/newsroom/spain-maintain-reform-momentum-to-enhance-economic-recovery-and-boost-inclusive-growth.htm>

until the programme country requests a loan to inject capital into its banks, at which point the notes are transferred to the recipient banks to serve as capital.

Thus, this issue and repurchase programme creates notes by issuing securities and immediately buying them back. It means that the EFSF and ESM don't have to overwhelm the market with a big short-term request for cash, said Strauch, who credits Head of Funding Ruhl with coming up with the idea together with CFO Frankel and an outside banking advisor. For the banks that receive aid, the attraction is having good-quality securities on their balance sheets.

Greece was an early test case for the floating rate notes, which the EFSF used to provide a €25 billion capital increase for the Hellenic Financial Stability Fund in April 2012, after Greece was granted its second euro area rescue package. Later, the notes were also used on a small scale in Cyprus under the ESM.

Spain, however, was where the issue and repurchase programme really proved its mettle. When Spain asked for its first disbursement in November 2012, the ESM had been in place for only a month. While legally sound, it was not yet an established issuer in the market – and it needed to find €40 billion in a hurry.

Had the ESM simply needed cash, it would have had to go to the market and take whatever money it could get at whatever price, Ruhl said. 'This would have meant that we had ruined our reputation before we even began.'

But the Spanish banks weren't looking for liquidity, they were looking for good-quality assets to hold as capital. This left the door open for a technical solution that gave the banks exactly what they needed and preserved the ESM's market flexibility.

'Instead of sending €40 billion in cash we sent €40 billion in bonds,' Ruhl said. 'We didn't have to go to the market, we didn't have to offer supply to the market. It meant we protected our existing curve. We protected existing investors. We weren't forcing our existing bonds to cheapen because we weren't flooding the market.'

Sending notes instead of cash essentially buys time for the ESM to accumulate funds. It's a way of delivering support immediately without disrupting the market. The notes have different maturities with sufficient time in between so that the ESM has plenty of time to raise money in the markets to pay off the next maturity. For Spain, the total amount was split into the following six notes:

Details of the notes provided by ESM – Spain

ISIN	Issuance date	Maturity	Type	Amount
EU000A1U98X6	01/02/2013	05/08/2015	30-month FRN	€1.865 billion
EU000A1U97C2	05/12/2012	11/02/2013	2-month bill	€2.5 billion
EU000A1U97D0	05/12/2012	11/10/2013	10-month bill	€6.468 billion
EU000A1U98U2	05/12/2012	11/06/2014	18-month FRN	€6.5 billion
EU000A1U98V0	05/12/2012	11/12/2014	2-year FRN	€12 billion
EU000A1U98W8	05/12/2012	11/12/2015	3-year FRN	€12 billion

Notes: FRN, floating rate note; ISIN, International Securities Identification Number.

Source: ESM

'This was no easy task,' Ruhl said, and yet it was the best way forward. 'Issuing to the market would have been extremely risky. We didn't know how many investors were prepared to buy the ESM bonds. In addition, it was the second half of November – the market was calming down, we were coming close to year end, books were closed, nobody wanted to enter into new risks. This was the worst period of the year to raise a huge amount of money, and this with an issuer who hadn't done any transactions in the market.'

To manage the process of creating and transferring the bonds as needed, the team created a variation of the approach used for the private sector involvement used in Greece. All worked well in the end.

Generally speaking, the ESM links the interest rate on the floating notes to the corresponding Euro Interbank Offered Rate, the daily reference interest rate known as Euribor. This rate moves in line with market conditions, meaning it can sometimes enter negative territory. The ESM later adjusted its approach to formally and explicitly set the interest rate floor for the notes at zero.

The ESM on trial: green light from Germany

26

To my great relief, in the summer of 2012, the Federal Constitutional Court rejected the criticisms of the ESM, provided certain conditions were met.

Wolfgang Schäuble

German Finance Minister (October 2009–October 2017)

On 10 July 2012, a panel of judges in the distinctive red robes of Germany's Federal Constitutional Court filed into a hearing that would ultimately decide whether or not the ESM could proceed. Resentment against Europe's new firewall was bubbling into legal challenges across the euro area, with cases pending in Estonia and at the Court of Justice of the European Union. But, given the timing – Spain and Cyprus had requested programmes only 15 days earlier – and the size of Germany's would-be contribution to the rescue fund, the Karlsruhe-based judges were seen as holding the future of the euro in their hands.

If the court ruled that ratifying the Treaty establishing the ESM²⁴⁵ would violate Germany's constitution, the new firewall would be unable to go forward. If the court gave the ESM its blessing, the euro

²⁴⁵ Treaty establishing the European Stability Mechanism, 2 February 2012.
https://www.esm.europa.eu/sites/default/files/20150203_-_esm_treaty_-_en.pdf

Judges in Germany's Constitutional Court prepare to announce their verdict on German ratification of the ESM Treaty and fiscal compact on 12 September 2012 in Karlsruhe, Germany.

Credit: Matthias Hangst/ Getty Images



area would have a firm foundation for its new permanent backstop. The high court had already ruled on the EFSF. In reviewing the ESM, its decision had even bigger stakes.

Chancellor Merkel's government was extremely sensitive to public opposition. Some 37,000 German citizens had signed a petition questioning the proposed ESM, including the Bavarian politician Peter Gauweiler of the Christian Social Union party, who had also led an earlier legal challenge²⁴⁶. Yet more tellingly, 54% of Germans polled hoped the Constitutional Court would block the ESM, according to a YouGov survey commissioned by the German news agency dpa and conducted between 3 and 5 September 2012²⁴⁷.

At the time, ratification of the ESM Treaty was proceeding apace across the euro area. On the date of the German Constitutional Court hearing, 10 July, nine countries had ratified it and that number would reach 14 by the end of August²⁴⁸. The German parliament had

²⁴⁶ Reuters (2012), 'German court removes hurdle to euro zone bailout fund', 12 September 2012. <https://www.reuters.com/article/us-germany-court/german-court-removes-hurdle-to-euro-zone-bailout-fund-idUSBRE88B00220120912>

²⁴⁷ Spiegel Online (2012), 'Mehrheit der Deutschen hofft auf Sieg der Euro-Gegner' ('Majority of Germans hope for euro opposition victory' (ESM translation)), 7 September 2012. <http://www.spiegel.de/wirtschaft/soziales/euro-rettung-deutsche-hoffen-auf-bundesverfassungsgericht-a-854421.html>

²⁴⁸ European Parliament (2014), 'German Constitutional Court decisions on EU anti-crisis measures', Briefing, July 2014. [http://www.europarl.europa.eu/RegData/bibliotheque/briefing/2014/140568/LDM_BRI\(2014\)140568_REV1_EN.pdf](http://www.europarl.europa.eu/RegData/bibliotheque/briefing/2014/140568/LDM_BRI(2014)140568_REV1_EN.pdf)

approved it on 29 June, but it could not become law until it was signed by Germany's president, a move that would not happen without the court's endorsement.

Jansen, the ESM's first general counsel, described the mood at the July hearing as 'very, very tense' – one German official working on the project told Jansen that his children had received death threats. 'It was a very bad situation,' he said. 'It was emotional. Some people were outraged.'

Like Managing Director Regling, Chief Economist Strauch and others in the ESM's senior leadership, Jansen was German and understood the quandary facing the country's leaders. 'The government knew it needed to be done,' Jansen said. But there was also ambivalence: 'They knew it was so unpopular that they could not praise it too much, because then they would not be re-elected, but they also could not risk letting the project fail because that would have been the end of Europe.'

Opponents of the firewall believed it would saddle Germany with the bill for profligacy elsewhere – and were determined to stop it. In the earlier case before the Karlsruhe-based top court, Gauweiler and a group of professors had filed a suit against the German government's support for Greece and the EFSF. On 7 September 2011, the court had ruled in favour of the euro area's firewall strategy, but it made clear that German lawmakers had to be consulted on all key steps²⁴⁹.

Then-German Finance Minister Schäuble said those initial Karlsruhe decisions were essential for gaining public acceptance. 'The basic approach behind the Federal Constitutional Court's rulings was to ensure that taking on overly high risks did not undermine the fundamental principle that the Federal Republic of Germany is a parliamentary democracy based on the rule of law, and that future parliaments should remain free to make their own decisions,' Schäuble said. 'In the worst-case scenario, Germany would have been liable for significantly more than the agreed share of 27%.'

Looking back, Regling views Germany as home to some of his most important and most difficult audiences. In numerous public and private appearances, Regling sought to explain that the rescue fund's

²⁴⁹ Germany, Federal Constitutional Court (Bundesverfassungsgericht), *Judgment of the Second Senate of 7 September 2011, 2 BvR 987/10 – paras. (1-142)*.

http://www.bundesverfassungsgericht.de/entscheidungen/rs20110907_2bvr098710en.html

programme financing comes from the market, not from the German budget, nor from the taxes that German workers have paid. While the German budget would bear some additional risk, it would not take on any new costs. 'I think I was helpful in calming down the hostility somewhat, but it was sometimes very severe,' he said.

In early 2011, for example, he spoke at a meeting of Germany's federation of family-run businesses alongside his one-time boss, former Finance Minister Theo Waigel. From their perch on the podium, even before they began to speak, they started to wonder about the hundreds of family entrepreneurs in attendance.

'It was so hostile,' Regling recalled. 'The way we were introduced was so aggressive, we were thinking: "Where's the emergency exit? Are we getting out of here unharmed?" It was really bad. It was one of the worst experiences I've ever had.'

Other ESM/EFSF team members also attempted to rally support at home. Secretary General Anev Janse appeared on Dutch television, and spoke to the European Parliament's budget audit committee and to Dutch members of parliament to make the case for a joint rescue facility for the euro area. As he remembers it, the idea was received with hostility amid a public perception that Greece had brought its crisis upon itself through its own policy mistakes.

Back in Luxembourg, the EFSF was doing its best to proceed calmly, as if there were not a momentous legal challenge pending. Regling, who had to keep international investors convinced that the euro area's rescue funds were a good place to invest their money, avoided comment on the case.

The rescue fund continued to manage its programmes for Ireland, Greece, and Portugal, and to monitor the progress of Spain's and Cyprus's requests for assistance. Hiring continued and the core managers kept up their institution-building efforts. At the time, the EFSF was aiming to expand its workforce, to around 75 from 47 employees by the end of 2012. People were very interested in how the firewall was developing, to the extent that Germany's Spiegel Online included a mention of the firewall's new logo in a September 2012 profile of ESM preparations²⁵⁰.

²⁵⁰ Spiegel Online (2012), 'ESM permanent bailout fund prepares for prime time', 5 September 2012. <http://www.spiegel.de/international/europe/permanent-euro-bailout-fund-esm-prepares-to-go-live-despite-law-suits-a-853892.html>

‘It was quite a risk,’ said Giammarioli, the ESM’s head of strategy and institutional relations. ‘I had to create my own division, to establish myself, to recruit, and to take strategic decisions for the institution as a whole. All the while, I was aware the ESM might not happen because there was this pending constitutional decision in Germany.’

Given the stakes, the ESM team couldn’t afford the slightest misunderstanding. German judges running the proceedings were experts in national law, not euro area policymaking, and were therefore not necessarily familiar with the firewall framework, Jansen recalled. Throughout the process, he and his colleagues were on hand to explain or clarify how the ESM would work, the role of national parliaments in its procedures, and other technical details.

‘The court is very serious and sober,’ Jansen said. ‘But seeing the symbols of the German state, the eagle, the flag and the European flags – you know history’s being written here.’

The July 2012 hearings took place in a temporary building, while the court’s main chambers were under renovation. In addition to a huge turnout of European media, US and Asian journalists joined the pre-hearing media crush in front of the court. Once proceedings began, the camera crews were sent out and official recordings took over.

Hearings in Karlsruhe normally last a few hours, but for this case the testimony stretched well beyond that, with only short breaks for the participants. Finance Minister Schäuble and other senior officials were present, underscoring the importance of the hearing for Germany as well as for the ESM.

‘Because it was a long day, we went to lunch at the nearby canteen. Everybody was queuing like at school, getting their food, and that included all the “important” people,’ Jansen said. While those officials who were grasping trays awaited the decision in Germany, another legal logjam was facing Regling’s team 2,000 kilometres away.

Two days after the German hearing, Estonia’s Supreme Court ruled on a similar case, assessing the treaty’s constitutionality before its ratification by Estonia. The challenge contended that the treaty impeded Estonia’s right to decide on its use of public funds – the paid-in and callable capital Estonia would contribute represented approximately 8.5% of the country’s GDP. On 12 July 2012, the court said that the ESM should proceed because Estonia faced

a greater threat from currency destabilisation than it did from any potential restriction on parliament's powers over the use of national resources²⁵¹.

Often the German Constitutional Court can take years to issue full rulings. When it came to the ESM challenge, such was the urgency that the court agreed to make a temporary ruling within two months. On 12 September, the day of the decision, the ESM/EFSF team trooped down to Karlsruhe. Jansen said the suspense lasted until the moment of the announcement, with concerned institutions preparing press releases for both outcomes and holding their breath to see how it would go. The decision was due at 10.00.

'Then everything happened really quickly,' Jansen said. 'The court basically said we can go ahead with it, but they had certain conditions.' It was essential, the court ruled, that any further German contributions to the ESM be subject to German parliamentary approval, and that the rest of the euro area acknowledge these German constraints²⁵². The Eurogroup's press release welcoming the decision went out within minutes, and the final steps in the German ratification process were set in motion.

For both the ESM and the EFSF, the German court proceedings were ultimately constructive, Regling said. Even though a part of German public opinion remains eurosceptic, the court's deliberation shows that the firewalls are compatible with German law. 'That, in the end, was very positive because they said clearly that setting up the EFSF and the ESM was in line with the German constitution,' Regling said.

Germany submitted its ratification papers on 27 September. This meant the treaty could enter into force and the ESM could be established, because the treaty stipulated that member states representing 90% of the ESM's capital contributions must ratify it before it could take effect. Germany's ratification pushed it over that threshold. The formal announcement that the ESM Treaty had entered into force came in a three-sentence 'note verbale' from the Council of the European Union

²⁵¹ Estonia, Supreme Court, *Constitutional judgement 3-4-1-6-12*, 12 July 2012.
<https://www.riigikohus.ee/en/constitutional-judgment-3-4-1-6-12>

²⁵² Germany, Federal Constitutional Court (Bundesverfassungsgericht), *Judgement of the Second Senate of 12 September 2012, 2 BvR 1390/12 – paras. (1-215)*,
https://www.bundesverfassungsgericht.de/SharedDocs/Entscheidungen/EN/2012/09/rs20120912_2bvr139012en.html

in Brussels, the ESM Treaty's depositary. Estonia then became the final euro area member state to ratify the treaty, just under a week later on 3 October.

The ESM existed on paper, but it wouldn't become operational until euro area finance ministers, meeting as the firewall's Board of Governors, approved everything from the rules of procedure to tax regulations for the salaried staff. There were only a few days to complete the internal preparations that had begun in September 2011 with what Anev Janse recalls as 'blue sky thinking' about the inner workings of the permanent fund.

Documents for the founding of the new fund were doublechecked and proofread on laptops supplied by the EIB, which had offered the EFSF start-up assistance. 'These were EIB laptops with EIB stickers on them and our binders even for the ministers' meetings were EIB binders, and you sometimes still see them at the ESM,' Anev Janse said.

In parallel, there was still some unfinished legal business. The Court of Justice of the European Union had been asked to weigh in after an April 2012 challenge by the Irish lawmaker Thomas Pringle, who argued that the establishment of a permanent firewall required a more extensive amendment to EU treaties than the simplified procedure that was used, including referendums if necessary under national law.

The case had been dismissed by the Irish High Court and then referred up to the Court of Justice²⁵³. In an extraordinary move, indicative of its novelty and precedent-setting potential, the full 27-member EU court heard oral arguments on 23 October 2012. It returned its ruling under an accelerated procedure on 27 November. It concluded that the EU Treaty amendment was valid, the ESM wouldn't violate the EU's no-bailout clause, and the permanent firewall could be established before final ratification of the amendment.

In support of its conclusion, the court cited sections of the ESM Treaty that 'demonstrate that the ESM will not act as guarantor of the debts of the recipient Member State. The latter will remain responsible to its creditors for its financial commitments'²⁵⁴. The treaty amendment

²⁵³ Court of Justice of the European Union (CJEU), *Judgment of 27 November 2012, Pringle, EU:C:2012:756*, <http://curia.europa.eu/juris/document/document.jsf?jsessionid=9ea7d2dc30dd3d9bb5367d7e44bd8046fea15ee63f87.e34KaxiLc3qMb40Rch0SaxyNchb0?text=&docid=130381&pageIndex=0&doclang=en&mode=lst&dir=&occ=first&part=1&cid=71469>

²⁵⁴ *Ibid.*

allowing the creation of the ESM would not add any new powers to the EU as a whole, which would otherwise breach the treaties.

At a stroke, any remaining legal clouds over the ESM were dispelled. The third article of the ESM Treaty concretised the purpose of the institution: '[t]o mobilise funding and provide stability support under strict conditionality, appropriate to the financial assistance instrument chosen, to the benefit of ESM Members which are experiencing, or are threatened by, severe financing problems, if indispensable to safeguard the financial stability of the euro area as a whole and of its Member States'²⁵⁵.

²⁵⁵ Treaty establishing the European Stability Mechanism, 2 February 2012.
https://www.esm.europa.eu/sites/default/files/20150203_-_esm_treaty_-_en.pdf

Financial milestone: the ESM starts operations

27

Europe needed a permanent, financial complement to monetary union.

Timothy Geithner

US Treasury Secretary (January 2009–January 2013)

Germany's ratification of the treaty cleared the way for the launch of the ESM at the next scheduled meeting of Eurogroup finance ministers, on 8 October 2012 in Luxembourg.

It was an opportune moment. Europe had put in place a robust crisis response plan. EFSF programmes for Ireland and Portugal were underway and Spain had secured rescue approval, Greece's acute troubles were in abeyance, and the hard bargaining over Cyprus's aid package was several months off.

Nonetheless, the fear that financial instability would continue to spill across national borders was still rampant. Investors were ducking for cover in perceived safe assets, inflating yields on what they viewed as riskier ones. While financial markets were leaping from one target to the next, the political response to contagion had, inevitably, taken shape more slowly. But it had been achieved.

In remarks at the Global Investment Conference in London on 26 July, ECB President Draghi had given policymakers the room they needed to manoeuvre, seizing the market's attention and refocusing it on the work done. He said the central bank would unleash overwhelming resources to defeat speculation about the possible breakup of the euro region.

‘Within our mandate, the ECB is ready to do whatever it takes to preserve the euro,’ Draghi said. ‘And believe me, it will be enough’²⁵⁶.

While Draghi’s declaration had an immediate stabilising effect on markets, it occurred in the broader context of more than two years of crisis fighting. A grand bargain of sorts had emerged between the euro area governments and the ECB, giving Draghi the confidence that the common currency was en route to becoming a more sustainable union.

‘There is more progress than has been acknowledged,’ Draghi said at the same London event, citing economic reform and deficit reduction at the national level, along with improved budgetary policing and plans for toughened bank supervision at the European level. And looking ahead to the foundation of the ESM, he added: ‘[...] also the various firewalls have been given attention and now they are ready to work much better than in the past’²⁵⁷.

A week after the London speech, the ECB cemented its resolve by announcing conditional plans to buy the bonds of programme countries on the open market²⁵⁸. When it published the technical features of these outright monetary transactions on 6 September, the ECB made clear that it would act on behalf only of countries in an adjustment programme administered by the rescue funds. ‘Strict and effective conditionality’ as part of an EFSF or ESM package would be a ‘necessary condition’ for the targeted ECB bond buying, the central bank said²⁵⁹.

The ECB pledge provided critical relief for the EFSF’s aid recipients, the drive for banking union, and the transition to the permanent rescue fund. The various crisis-fighting strands were tied closely together, as Germany’s *Die Welt* newspaper noted in a commentary on how the ESM’s debut would ‘fundamentally change the monetary union’²⁶⁰.

While the markets were impressed by the central bank’s undertaking, ‘the ESM will play an important role, because Draghi has linked his intervention to the rescue fund,’ *Die Welt* wrote. It would take political backing for a distressed country – as demonstrated by being in an ESM programme – to trigger ECB action.

²⁵⁶ ECB (2012), ‘Verbatim of the remarks made by Mario Draghi’, Global Investment Conference, 26 July 2012. <https://www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html>

²⁵⁷ Ibid.

²⁵⁸ ECB (2012), ‘Introductory statement to the press conference (with Q&A)’, 2 August 2012. <https://www.ecb.europa.eu/press/presconf/2012/html/is120802.en.html>

²⁵⁹ ECB (2012), ‘Technical features of outright monetary transactions’, Press release, 6 September 2012. https://www.ecb.europa.eu/press/pr/date/2012/html/pr120906_1.en.html

²⁶⁰ *Die Welt* (2012), ‘Multimilliarden-Rettungsfonds verändert die EU’ (‘Multi-billion rescue fund changes the EU’ (ESM translation)), 7 October 2012. <https://www.welt.de/wirtschaft/article109678815/Multimilliarden-Rettungsfonds-veraendert-die-EU.html>



The ESM is born: Managing Director Klaus Regling, flanked by General Counsel Ralf Jansen and Secretary General Kalin Anev Janse at left and Eurogroup President Jean-Claude Juncker at right, at the inaugural meeting on 8 October 2012 in Luxembourg.

Credit: European Union

The Eurogroup agenda²⁶¹ on the ESM's official start-up date included progress reports on the programmes for Greece, Spain, and Portugal, a look at the talks with Cyprus, discussions of longer-term euro area reforms, and preparations for the meeting of the Group of Seven finance ministers and central bankers a few days later in Tokyo.

This Eurogroup was held in Luxembourg, the venue for EU ministerial meetings every April, June, and October. Finance ministers gathered in a building used for meetings by the Council of the European Union, an edifice that had reopened in April 2012²⁶² after nearly a decade of renovation and reconstruction.

The day's 'milestone' – to quote Rehn, then the European commissioner for economic and monetary affairs and the euro – was the first order of business, with the ministers convening as the ESM's Board of Governors for the first time and declaring the permanent fund operational. They met in the same room as they would later for the Eurogroup. It was the only feasible setting: the rescue fund moved into a more permanent home only two months later in December. In October, it didn't have the space to host a top-level meeting.

The ESM's inauguration prompted reflection inside and outside the meeting chamber. 'Two and a half years ago when Greece first found itself cut off from the markets, we had absolutely no instruments at our disposal to intervene and provide conditional financial assistance,'

²⁶¹ 'Eurogroup meeting – October 2012: Roundtable', Video, 8 October 2012.

<https://tvnewsroom.consilium.europa.eu/permalink/164791>

²⁶² Luxembourg, Official government portal (2012), 'Ouverture du nouveau centre de conference' ('Opening of the new conference centre' (ESM translation)), April 2012.

<http://www.luxembourg.public.lu/en/actualites/2012/04/01-ckk/index.html>

ESM Managing Director Klaus Regling and members of the Eurogroup mark the official setting up of the ESM in Luxembourg on 8 October 2012.

Credit: European Union



Rehn told a press conference. ‘Today, in fact nine months earlier than initially foreseen, we are marking the entry into force of the European Stability Mechanism, which is an important achievement’²⁶³.

ESM establishment highlights

October 2010: ESM idea is born, with planned start date of 2013.

March 2011: Euro area agrees ESM will have €500 billion capacity, backed by €700 billion total capital and €80 billion paid-in capital.

July 2011: First draft of ESM Treaty agreed, but never ratified.

December 2011: ESM Treaty updated, start date pulled forward to 2012.

February 2012: Final text of ESM Treaty agreed.

June 2012: Euro area agrees to develop direct bank recapitalisation tool.

September 2012: ESM Treaty ratification process concludes.

October 2012: ESM opens for business. Members begin to make paid-in capital instalments.

December 2012: ESM moves to new headquarters and makes first disbursement, to Spain.

January 2013: EFSF staff become ESM employees.

April 2014: The 17 founding Members of the ESM pay final tranche of paid-in capital.

December 2014: Direct bank recapitalisation tool declared operational.

²⁶³ ‘Eurogroup meeting – October 2012: Press conference – Part 4’, Video, 8 October 2012. <https://tvnewsroom.consilium.europa.eu/permalink/164815>

European media marked the occasion with maps and flowcharts highlighting the structural differences between the ESM and its predecessor. *Ouest-France*, a French newspaper, urged its readers not to be cynical about the founding of another institution for the region. ‘It doesn’t have a simple name and is unlikely to make Europe more appealing to those who only see it as a hotchpotch of opaque institutions,’ the newspaper said. ‘And yet! The inauguration yesterday of the European Stability Mechanism is an important step on the winding road of the economic and monetary union’²⁶⁴.

In Germany, the *Handelsblatt* business newspaper noted that the transition from a temporary to a permanent mechanism was far more than a ‘formality’. In addition to possessing its own resources, *Handelsblatt* said that the ESM would provide ‘democratic legitimacy’ for any ECB bond purchasing, under the conditions set by the central bank²⁶⁵.

Bond markets saw October 2012 as a watershed and a culmination of the mid-2012 actions to stabilise the currency union. As a result, bond yields across the euro area fell back from their crisis peaks and for most countries entered a new and more sustainable range. In 2015, when the euro was again put to the test, financial market contagion erupted on a smaller scale than when there had been no permanent firewall.

For ESM staff who were present at the 2012 creation, more than a year of organisational planning, drafting, and fine-tuning – often in 80- to 100-hour working weeks – was condensed into a 12-point agenda that the finance ministers got through in barely an hour.

‘It was like training for the World Cup, then making it to the finals – super exciting,’ Secretary General Anev Janse said. But after the Board of Governors meeting, there was still another half to play the next day. It wasn’t until after the Board of Directors approved further internal procedures that rescue fund staff could return to the office to celebrate.

²⁶⁴ *Ouest-France* (2012), ‘Le Mecanisme Européen de Stabilité, trousse d’urgence pour la zone euro’ (‘The European Stability Mechanism, emergency kit for the euro zone’ (ESM translation)), 9 October 2012. <http://jactiv.ouest-france.fr/actualites/zoom-sur/lactu-jour/mecanisme-europeen-stabilite-trousse-durgence-pour-zone-euro-10369>

²⁶⁵ *Handelsblatt* (2012), ‘Ist der neue Rettungsschirm nur ein Feigenblatt’ (‘Is the new rescue fund just a fig leaf?’ (ESM translation)), 8 October 2012. <https://www.handelsblatt.com/politik/international/esm-und-ezb-ist-der-neue-rettungsschirm-nur-ein-feigenblatt/7220812.html?ticket=ST-3186182-OFRIbMKP9NsQtGDFt31P-ap2>

A growing family:
ESM staff and service
providers pose for a group
photo in October 2012.

Credit: ESM archives



On the personnel front, the ESM's inaugural meeting named Juncker, then head of the Eurogroup, as the permanent fund's first chairman of the Board of Governors, and Regling as both managing director and sole political appointee. The ESM would be formally without any staff until 1 January 2013, when most of the EFSF staff's contracts would be officially converted into ESM contracts. In the meantime, the EFSF staff would handle the ESM's tasks.

'For the future, whenever you have questions related to the ESM, please put them to Klaus,' Juncker said at a joint press conference with Regling²⁶⁶. A day later, Regling was off to Tokyo for the annual meeting of the IMF, to start marketing the ESM to global investors²⁶⁷.

²⁶⁶ ESM (2018), 'Highlights of press conference – ESM inauguration meeting,' 8 October 2012, Video, 13 June 2013. <https://www.youtube.com/watch?v=x7jkkycJC1g>

²⁶⁷ 'Eurogroup meeting – 8 October 2012: Press conference – Part 5', Video, 8 October 2012. <https://tvnewsroom.consilium.europa.eu/permalink/164816>

Corporate governance: the ESM's operating manual

28

We followed the best practices of peer institutions in setting up our framework and structure, but it was part of our unique challenge to tailor our set-up to ESM needs.

Florian Zinoecker

ESM Head of Corporate Governance and Internal Policies

Even before the ESM became a permanent fixture, the need for a governance framework for Europe's newest international financial institution became pressing. Secretary General Anev Janse had worked hard to establish strong relations between the institution and its governors and directors. When Florian Zinoecker, the ESM's head of corporate governance and internal policies, joined on 1 July 2012, he was given little time to craft the ESM's Board structures and procedures, and distil them into legal form.

'We had literally the summer and a month to finalise all these important governance policies,' Zinoecker said.

The ESM had templates to go by, of course. Alumni of the EIB, the IMF, or the European Bank for Reconstruction and Development would instantly recognise the ESM's three-tiered structure; however, none of those were an exact fit for the new firewall. The objective was to set up a governance structure for an effective and fast-paced crisis response mechanism that would also safeguard transparency and accountability at the highest levels.

At the top is the Board of Governors, made up of finance ministers of the euro area countries, who set the strategic direction and take critical decisions on rescue programmes. One level down is the Board of Directors, composed of the ministers' deputies or other high-profile officials from the ministries of finance, with more hands-on operational responsibilities. Anchoring the system is the Luxembourg-based Management Board, headed by the ESM managing director, which prepares and implements the decisions of the Board of Governors and the Board of Directors and conducts the ESM's current business.

The ESM has a streamlined organisational structure, without the rotating casts of national appointees typical of some other international or European financial institutions. The managing director, Regling, is the sole Management Board member appointed by the ESM Board of Governors; the remaining five members were appointed by Regling from within the ESM's expert ranks. The governing bodies make decisions on proposals from the ESM managing director. In terms of accountability, the ESM governors are the finance ministers of the euro area countries and, as members of the national governments, they are accountable to their national parliaments. Some ESM Members also conduct national parliamentary procedures to approve important ESM decisions.

As part of its governance and proactive shareholder relations, ESM staff are in frequent contact with national finance ministries, often through a secure online gateway called the ESM Board Portal, which enables the posting of documents and agendas. In addition to day-to-day contact with other institutions regarding programmes and other operational matters, there are regular conference calls in which Luxembourg-based staff and national officials discuss matters such as the ESM's annual budget, financial statements, and the code of conduct. These technical calls facilitate consensus on draft proposals that are sent to the Board of Directors for approval and are an 'essential feature' of the ESM's interaction with the national ministries, Zinoecker said.

Regling often meets with national parliaments across Europe to explain the purpose or specific actions of the rescue fund and its role in euro area governance. When Latvia adopted the euro in 2014 and Lithuania followed a year later, Regling briefed parliamentary committees in those countries on the ESM's structure and functioning. On a voluntary basis and in the spirit of transparency, Regling has also had informal exchanges of views with European Parliament committees and working groups.

Once a year, in September, the ESM hosts a two-day seminar – ESM Shareholders' Day – with national finance ministry officials to help deepen their understanding of the rescue fund's inner workings. During the rest of the year, national officials and parliamentarians are regular visitors to the ESM's headquarters.

In keeping with its nature as a crisis response vehicle, the ESM can act rapidly when it has to. Standard notification periods for conference calls, technical talks, document preparation, and meetings of the Board of Governors or Board of Directors can be accelerated in the heat of a crisis.

'We have provisions for very urgent decisions that we had to resort to for programme countries,' Zinoecker said. 'We can also shorten our standard timelines for other urgent decisions.'



Officials representing ESM Members attend the annual meeting in 2016.

Credit: Steve Eastwood/ESM

Intense work on the governance structure in the summer of 2012 culminated with the inaugural meeting of the Board of Governors, on 8 October 2012. 'All of the documentation had to be circulated to the board 15 days in advance of the meeting and, as I had only just started in July, that gave us a very short window to create and finalise them,' said Zinoecker. One of the first orders of business was putting the structure in place. Along with Regling, the first external audit firm and the five members of the Board of Auditors were appointed that day.

Board of Auditors members serve non-renewable three-year terms in an independent capacity. The terms of the first appointees were staggered between three and four years, so that the entire Board of Auditors wouldn't have to be replaced at the same time. Of the five members, two are nominated by the chairperson of the Board of Governors, two by national audit institutions based on a system of rotation, and one by the European Court of Auditors. Holding meetings once a month, members of the Board of Auditors review the ESM financial statements, perform their own audits, and monitor the internal and external auditors.

From the outset, Regling deemed it imperative to equip the ESM with high standards of risk detection and mitigation. On 9 October 2012, less than 24 hours after the ESM's inauguration, the Board of Directors met to finalise high-level principles for risk management, which, together with internal controls, are critical to the ESM's credibility as an international financial institution.

Like many of its peers, the ESM operates with a three-lines-of-defence model that functions like a financial security perimeter, ensuring that credit, market, liquidity, and operational risks are tightly controlled.

The first line of defence covers the day-to-day management of risk, which is the responsibility of each department and business function. All staff are required to be aware of risks relating to their operations, identifying and reporting any issues up the hierarchy.

The second line of defence is provided by the risk and compliance department, headed by the chief risk officer. Independent of the daily flow of ESM business, this department tracks potential exposures to threats such as adverse movement of interest or exchange rates, the failed settlement of a securities transaction, the inability to raise funds on time, or the holding of securities that cannot be sold or

offset due to low market liquidity. It continuously monitors the full implementation of the investment, funding and other guidelines adopted by the shareholders. It makes mitigation proposals, stays up to date on risk management methodologies, and provides early warnings to the managing director and Board of Directors. Perhaps its most important task, however, is to foster a risk awareness culture throughout the organisation, ensuring policies are implemented and risks appropriately managed.

‘The risk management team implements and maintains a state-of-the-art risk framework, supporting the ESM’s long-term financial stability,’ said Katerina Arvaniti, the ESM’s deputy head of risk. ‘By defining risk appetite and limits, we help the ESM fulfil its mandate to safeguard financial stability in the euro area. The team’s evaluations ensure that the institution avoids unnecessary risks and allays those inherent to its mandate, instilling confidence in its shareholders and its investors.’

An independent internal audit function provides the third line of defence. The head of internal audit reports to the managing director, ensuring risk management controls are operating properly and efficiently.

Not all risks can be measured in euros and cents. Political events that are beyond the ESM’s control, for example, could upset the financial markets and make it harder to raise funds. But the three-tiered structure for risk management sets out clear lines of authority and responsibility.

A risk statement set by the Board of Directors lays out the level of risk considered acceptable, and is reviewed annually. In addition, the ESM has an internal risk committee that ensures risk policies are implemented. Periodically, it conducts a risk self-assessment, which is reported to the managing director.

The managing director is responsible for the implementation and functioning of the risk management framework, for ensuring adequate risk reporting to the Board of Directors, and for further developing the risk policy. The chief risk officer and the internal auditor both report directly to the managing director as well as to, respectively, the Board Risk Committee and the Board of Auditors, to ensure their independence.

Rigorous internal controls are hardwired into the ESM's operating manual. Here, a staff member discusses internal controls at a 2016 meeting.

Credit: Steve Eastwood/ESM



'No other international financial institution has managed to achieve such a mature risk management framework, including the internal control framework, within such short timelines,' said Yana Djoneva, the ESM's deputy head of corporate governance and internal policies.

ESM staff are made aware of the firewall's approach to risk as soon as they start work. This includes face-to-face training with a compliance officer, who provides a briefing on the code of conduct. All staff members must file an annual declaration certifying their compliance with the code of conduct. Beyond that, those classed as 'designated senior officer' must disclose their financial and business interests to the compliance officer.

Employees take part in regular risk and compliance training exercises, with many training modules online and completion rates monitored. Interactive sessions with visiting risk management experts reinforce active risk awareness, and enhance knowledge. Compliance certifications are renewed annually.

Recognising that corporate culture filters down from the person in charge, Regling has voluntarily published his declaration of financial interests. The ESM's compliance officer, Eva Kinczer, said Regling also uses weekly all-staff meetings to 'reiterate the utmost importance of ethical and professional behaviour as well as the need to act with integrity and in full compliance with policies and procedures.'

The ESM has made a concerted effort to apply environmental, social, and governance best practices to all of its internal operations, and it continues to improve them on an ongoing basis. These efforts can range from investing in so-called green bonds to encouraging its staff to recycle and use public transportation. The ESM works to ensure it conducts its activities with the highest standards of integrity and to maintain a comprehensive and transparent governance system. The ESM also has earned a SuperDrecksKëscht certificate from the Luxembourg government on waste avoidance and proper separation of recyclables.

The ESM started investing in sustainable, or 'green,' assets as early as 2014, with an exposure of €300 million on average. As a result, it has been able to diversify its portfolio while supporting the development of sustainable investments. More broadly, the ESM's investment strategy is inherently socially responsible because it mainly invests in bonds issued by public entities. In 2017, for instance, excluding the cash held in central banks, the ESM allocated more than 60% of its invested capital to sovereigns, government agencies, and supranational entities, with the remainder invested in covered bonds. Going forward, the ESM will be looking at further steps to enhance its role as a responsible investor.

~ Investment strategy continues in Chapter 35 and in 'Focus – An unusual money market transaction' in Chapter 37.

In 2017, Transparency International, the Berlin-based global anti-corruption watchdog, reviewed the rescue fund's practices as part of a larger examination of decision-making by euro area institutions. The report said that the ESM 'boasts world class audit arrangements, a code of conduct that ensures a high level of integrity, and a dedicated whistleblowing procedure that reflects best practice'²⁶⁸.

²⁶⁸ Transparency International EU (2017), From crisis to stability: how to make the European Stability Mechanism transparent and accountable.

http://transparency.eu/wp-content/uploads/2017/03/ESM_Report_DIGITAL-version.pdf

‘We have tried to endorse transparency to the greatest extent possible and we have followed up on the recommendations,’ said Niyat Habtemariam, the ESM’s governance and internal policies officer.

- 🔄 Institutional history, which began in Chapters 11 and 21, continues in Chapter 30.

Capital backing: key to top ESM credit rating

29

We want to build a capacity to withstand a potential euro crisis that could have an impact even wider than the previous one.

Cosimo Pacciani
ESM/EFSF Chief Risk Officer

When the ESM was launched in October 2012, it was important to secure the highest possible credit ratings, as the EFSF had done for its debut in 2010. The ESM would be starting anew, and AAA certification would tell investors that the issuer is a low-risk investment, enabling the ESM to borrow at the best market rates.

The ESM's closest peers are other supranational institutions that sell marketable debt, such as the EIB. Most of those existing institutions have stable operations and a familiar mandate, so they are able to renew their ratings with little fuss. In contrast, the ESM was an untested entity created at a time of extreme market nervousness. And its remit was to help countries that markets didn't want to lend to.

Thanks to the ESM's paid-in capital structure, Managing Director Regling was confident that the new firewall was on a surer footing than its temporary predecessor – but there could be no certainty. The ESM received its first paid-in capital instalments just after its official debut.

'Rating agencies are very cautious,' said Matjaž Sušec, the ESM's deputy head of strategy and institutional relations. 'The mandate of the ESM is

that of a crisis resolution mechanism and therefore the rating agencies always approached it more conservatively than other issuers.’

Earning market confidence has always been a priority. From the start, Regling had an internal analytical team tasked with working closely with the rating agencies and making sure they were using the best information. Both the EFSF and the ESM would need to continue to be regular players in the fixed-income markets.

In the very beginning, the raters were still judging the ESM based on the outlook for its Members, just as they had assessed the EFSF. But that soon changed. ‘We insisted on having the rating agencies fully value the strength of the ESM,’ Sušec said. ‘The rating agencies started appreciating the ESM’s robust financial structure only gradually as the contagion risk in the euro area abated. This was also a sign of the credibility of the ESM as an institution.’

The ESM, like the EFSF, started out with the highest possible ratings – AAA from Fitch and Aaa from Moody’s – and the levels for both rescue funds have not fallen significantly over time.

The ESM has seen just one rating change and a handful of other rating events. The most momentous was in November 2012, when Moody’s downgraded France and it also downgraded both the ESM and the EFSF. The firewall rating has since become less dependent on French circumstances.

In addition, Moody’s, which had assigned the ESM a negative outlook at the outset, changed the outlook to stable in 2014 and to positive in May 2018.

‘This was a very good development because it showed that Member support is not the only factor that matters for the ESM’s rating,’ Sušec continued. ‘It also showed that the ESM was an established issuer, and that was very important.’

The next ESM rating event took place at the end of 2014, when, for three months, Fitch changed the rescue fund’s outlook to negative before returning it to stable.

The ESM has been rated AAA by Fitch and Aa1 by Moody’s since late 2012. The EFSF has been rated AA by Fitch since December 2014; AA by Standard & Poor’s since November 2013; and Aa1 by Moody’s since November 2012. Both funds also have an unsolicited AAA rating from the firm DBRS, which the ECB also recognises as a trusted source of evaluations and which began rating the ESM in 2014.

 For the ESM’s and EFSF’s complete rating history, see [Annex ‘EFSF and ESM rating history’](#).

Focus

How do you solve a problem like a downgrade?

When Moody's downgraded France and the ESM in late 2012, it also moved the EFSF to Aa1 from Aaa, which upended the EFSF's immediate borrowing plans to issue a bond²⁶⁹. The downgrade to one of its biggest Members meant the EFSF no longer had the quality of guarantees needed to back its planned bond issue.

Since the rescue fund's liquidity needs couldn't wait, the team came up with a novel twist to solve the problem. Ruhl, the ESM's head of funding and investor relations, and Fouquerey-Carrick, investor relations expert, tell the story:

Ruhl: 'When France was downgraded, we were in the market with a transaction. We couldn't open the books, in the end, as we did not have enough guarantors with a similar rating to the EFSF rating, because of that French downgrade. We had to stop the transaction and find a solution. The short-term ratings, for paper of less than 365 days, weren't affected by the downgrade. So we thought about this for two or three days and then decided to do something very unique: a 364-day bond.'

Because the issue would have a maturity of less than one year, its rating would fall under short-term metrics and steer clear of long-term comparisons. As France's downgrade did not affect its short-term borrower rating, the EFSF did not face the same guarantor shortage. There was just one more hurdle: persuading the bankers to give it a shot.

Ruhl: 'The bankers said: "This will never fly." It was a lot of work, especially for me, to talk to them many times over the weekend. Saturday and Sunday, I spent most of my time on the phone trying to convince them.'

Fouquerey-Carrick: 'I remember we spoke to the banks and they confirmed they'd discussed the plan. But in the background I could hear reluctance. They were saying: "We really don't think this is a good idea." But Siegfried insisted: "No, this is a thing we need to do, and we'll get it done." They were still unpersuaded: "We're really not sure about this," but Siegfried remained undeterred: "We are going to do it."'

Ruhl: 'I was super convinced. Based on my view of the market, of what investors want to see and where I thought demand would be – there were

²⁶⁹ EFSF (2012), 'EFSF reacts to recent developments with the announcement of a one-year bond', Press release, 27 November 2012. <https://www.esm.europa.eu/press-releases/efsf-reacts-recent-developments-announcement-one-year-bond>

a lot of details you put together like a puzzle, like a mosaic. You think, will it work or not? My impression was: it will work. In the end, it's a gut feeling.'

Ruhl: 'Finally, Monday morning the bankers were persuaded and we opened the books for a 364-day bond²⁷⁰. It was a very successful trade with a final size of €7 billion. Looking back at the situation with France's downgrade and the 1-year, €7 billion transaction, of course it was difficult to challenge the experienced bankers. You offer them a trade where they can make money and they tell you: "We don't believe in that." It's not easy to withstand. But on the other hand, it's quite simple because there are only two options: we do it or we don't. If we do it the risk is that we fail, and we don't have the money. But if we don't do it, we definitely don't have the money.'

²⁷⁰ EFSF (2012), 'EFSF places €7 billion one-year bond', 27 November 2012.

<https://www.esm.europa.eu/press-releases/efsf-places-%E2%82%AC7-billion-one-year-bond>

Fitch placed the ESM on a similar negative outlook in October 2014, again in connection with developments in France. But in this case the ESM's analytical team worked closely with the rating agency to show how its methodology was overstating the risk, and two months later, in December, Fitch affirmed the ESM's AAA rating and returned the outlook to stable. Since mid-2017, the ESM has been rated two notches higher than the EFSE, mainly because of the paid-in capital that gives it independence.

'All Members, including all the programme countries, paid us capital, so we have it in hand. It doesn't matter whether the countries that gave it to us are downgraded or not,' Regling said. 'We have the paid-in capital, and there's also €620 billion in callable capital. Of course, for the callable capital, rating agencies take into account that some of those who would be called upon might not be able to provide the money in a crisis, but €80 billion is still a big buffer before one gets to that stage.'

One of Regling's biggest jobs, therefore, is keeping up relations with credit-rating agencies as well as with the asset managers, the sovereign wealth funds, and the many other investors that entrust the ESM with their money.

'That's why I travel constantly, certainly to the big investors,' the ESM chief said. 'Some of them want to see me. At one point, a large investor I had never visited said, "We want to see the boss at some point," so I thought, Okay. I get the message. If they want to see me, I'd better go.'

At home in Luxembourg: a look inside the ESM's offices

30

The ESM's founders set out to create a modern, innovative, entrepreneurial public institution.

Kalin Anev Janse
ESM/EFSF Secretary General

The ESM headquarters in Luxembourg's Kirchberg district, the long-time home of private sector banks and public sector European institutions, has a major advantage over some older institutions: it was unencumbered by legacy systems – or even walls. This means its physical and information technology (IT) infrastructure were purpose-built.

'We were in a very lucky position because in many areas, we could start from scratch and design it through,' said Boris Fallnicht, ESM facilities manager.

Designers took inspiration from the finance sector, contemporary public buildings, and even Silicon Valley start-ups to create a creative, problem-solving environment that would function within an institutional framework. 'We are not a start-up anymore – but we try to keep that spirit alive in a mature long-lasting institution,' said Secretary General Anev Janse.

Office blueprints: banks, public buildings, and tech start-ups provided the inspiration for the ESM's interior buildout and décor.

Credit: Steve Eastwood/ESM



Breaking down walls is an operative principle. The management team's offices are spread throughout the building and accessible to all, not cordoned off in a C-suite. To instil the out-of-the-box thinking that was the hallmark of the ESM's breakneck, crisis-driven inception, the set-up features community spaces, as well as movable walls and partitions so room layouts can be re-arranged to accommodate meetings of different size and purpose.

The office's buildout and décor were constrained by two factors: ensuring staff could do their jobs come what may and safeguarding the security of the ESM's people, infrastructure, computer, and communications systems.

With two organisations sharing a staff and a roof, even day-to-day business entails a degree of complexity. To track the firewalls' finances, for example, the ESM's accountants need to use two sets of accounting rules. As a treaty-based international financial institution, the ESM uses the rules laid out in the EU accounting directive²⁷¹ to

²⁷¹ 'Directive 86/635/EEC of the Council of the European Communities of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions, as amended by Directive 2001/65/EC of 27 September 2001, by Directive 2003/51/EC of 18 June 2003 and by Directive 006/46/EC of 14 June 2006.' https://www.caplax.eu/en/Areas%20of%20Law/Capital_Markets_Law/European_Law/9066/Richtlinie_86_635_EWG.htm

manage its books. The EFSF, with its private sector legal structure, uses International Financial Reporting Standards. 'The set-up is quite different and they are not all that compatible,' said Thomas Pies, head of finance and control.

Remote, reliable, secure data access was crucial. At the height of the crisis, staff knew they could be called on at any hour of the day or night, so the computing network had to extend to wherever they were. The EFSF was soon aligned with major corporations with robust teleworking systems to allow colleagues to videoconference in, from home, from a roadshow, or, in the event of a crisis or natural disaster, from an off-site office. Dave Wallace, the ESM's head of information technology and operations, called the globalised office 'one of our first mantras. We saw it as key that people could work from anywhere at any time as if they were in the office.'

Security was also essential for hosting high-level ministerial gatherings. Just eight months after its inauguration, the ESM held its first annual Board of Governors meeting in June 2013 at the new premises. The ESM needed to accommodate 17 finance ministers and their delegations, manage the flow of security, provide media access, and handle food and beverage delivery during and around discussions and photo ops – in other words, all the logistical minutiae of hosting a major event.

'We had to coordinate everything with the Luxembourg police, so that the transfers were swift and safe,' Fallnicht said. 'We had to ensure the tightest access protocols for participants due to the political temperature of the times.'

In 2013, the ESM set up a disaster recovery site. Unlike the shared back-up facilities used by banks in London or Paris, the ESM is the sole operator of its site. In the event of a sudden need to evacuate the headquarters, for example, it wouldn't have to compete with rival tenants for the backup space.

Staff work out of the recovery site at least twice a year as part of disaster response training. Some departments will temporarily relocate there during upgrades or refits of the main office. ESM officials have examined a wide range of scenarios that could occur without warning and could hobble daily operations – from the outbreak of an epidemic, to a cyberattack, or even the local loss of electricity.

‘We are very strong on scenario analysis, and we have a wide range of events for which we have a pre-planned response,’ said Djoneva, deputy head of ESM corporate governance and internal policies. ‘We need to be able to operate on a 24/7 basis.’

From a systems perspective, the ESM needs to ensure that its physical and digital infrastructures can withstand disaster, natural or otherwise. This was understood right from the start, when the EFSF rented a small generator to keep power flowing to key functions in the event of a blackout. The first uninterrupted power supply for the whole building was installed in 2014, followed by a customised system.

Every year, the ESM also conducts an incident management exercise to train and test the responsiveness of top management. There is a certain theatrical staging to this. In one room sit experts who simulate a real-life incident, peppering senior ESM managers in another room with incremental bits of information as the fictional crisis unfolds. ESM spokespeople are also involved, since a major part of emergency response is communicating with the public.

Unlike the exercises, however, the threats themselves can be all too real. In a 2017 campaign, eight letter bombs were sent to institutions, including the German finance ministry and the IMF office²⁷² in Paris. A booby-trapped parcel addressed to ESM Managing Director Regling was intercepted at Athens airport, as was one addressed to Eurogroup President Dijsselbloem²⁷³. Together with Luxembourg authorities, the ESM took emergency security precautions to protect Regling and ESM staff.

In terms of its information technology network, the ESM grew up in the cloud era, and could ‘leapfrog many of our peers by adapting a fully outsourced strategy leveraging the latest cloud systems and thinking,’ Wallace said. ‘This allowed the ESM to scale up quickly and flexibly, adopting the newest technology along the way.’

²⁷² *New York Times* (2017), ‘Letter bomb injures worker at International Monetary Fund office in Paris’, 16 March 2017. <https://www.nytimes.com/2017/03/16/world/europe/paris-imf-bomb.html>; and BBC News, ‘Paris IMF letter bomb that injured one was sent from Greece’, 16 March 2017. <https://www.bbc.com/news/world-europe-39292671>

²⁷³ *DutchNews.nl* (2017), ‘Dutch finance minister target of Greek parcel bomb: Report’, 21 March 2017. <https://www.dutchnews.nl/news/2017/03/dutch-finance-minister-target-of-greek-parcel-bomb-report/>; *Euractiv.com* (2017), ‘Dijsselbloem “mail bomb target”’, says spokesman, 22 March 2017. <https://www.euractiv.com/section/politics/news/dijsselbloem-mail-bomb-target-says-spokesman/>

As well as keeping on top of technology, the ESM is keen to encourage innovation. Its Technology Officer Rogelio Rodriguez programmed an expert system – a precursor of artificial intelligence – to probe for functional inconsistencies in the ESM's 250 daily financial-system reports. It's nicknamed Jarvis. Automatic scanning of spreadsheets not only saves human time – for example removing the need to validate the daily cost-of-funding calculation by hand – but also helps address any bugs that crop up. Lately, Rodriguez has been leading the team's investigations into the potential benefits for the ESM of deep data and artificial intelligence, as well as blockchain-type distributed ledger technologies. Blockchain, a secure method of asset tracking, has the potential to revolutionise the way capital markets operate, given the evolving need for trusted third parties and improved transaction settlement. Deep data analytics could maximise the value of specific data streams while minimising needs for large data storage. Artificial intelligence could lead to radically more efficient systems.

Jelena Zelenović Matone is another ESM technology pioneer. A former refugee of the Yugoslav civil wars, she joined the ESM in 2014. Thanks to her technology expertise, gained from working in the private sector in Canada, she anticipated some of the ESM's needs before they had fully emerged such as the setting up of security protocols within the information technology department. Zelenović Matone said that, in her time at the ESM, she has been given the time and scope to consider technical approaches that were still off the radar, which is testimony to the ESM's commitment to excellence. 'They gave me the freedom to further explore these areas, such as IT general controls, automated IT application controls, end-user computing controls, and policies and procedures that were yet to be developed at the ESM.'

The frameworks and controls she designed, along with her quarterly risk dashboards, made a strong impression on the ESM's auditors and have become an integral part of internal oversight. Zelenović Matone also has been sought out by other international financial organisations to share technology-related internal control and audit solutions.

To share know-how and to stay abreast of the latest developments, Anev Janse is active in both public and private sector networks. Together with peer institutions, the ESM set up a financial technology forum for staff to discuss the latest trends and share best practices both online and in person.

Anev Janse is often asked to share the ESM's experiences around the globe on becoming part of a start-up-oriented financial technology circle to keep abreast of new ideas and test products. 'We learn and they learn,' Anev Janse said. 'That's also the way to push innovation in Europe.'

Crisis in Cyprus: 'no negotiating power, no credibility'

31

The overall consensus is that Cyprus has done much better than anybody expected. The odds weren't very promising, but now it is doing well.

Olli Rehn

European Commissioner for Economic and Monetary Affairs and the Euro
(February 2010–July 2014)

Cyprus was struggling with the broader ramifications of the crisis when the 2012 writedown of privately held Greek debt led to more than €4 billion²⁷⁴ in losses for Cypriot banks, or in excess of 22% of GDP. With a banking sector that was then about six and a half times the size of the country's economy, it was virtually impossible for Cyprus to overcome this blow on its own. Public finances also were deteriorating, with the debt-to-GDP ratio of 80% in 2012, compared with about 46% in 2008 on the eve of the crisis²⁷⁵.

²⁷⁴ IMF (2013), 'Cyprus: Letter of intent, memorandum of economic and financial policies, and technical memorandum of understanding', p. 3, 29 April 2013.

<https://www.imf.org/external/np/loi/2013/cyp/042913.pdf>;

Demetriades, P. (2017) *A diary of the euro crisis in Cyprus: Lessons for bank recovery and resolution*, Palgrave MacMillan, Cham.

²⁷⁵ Eurostat (n.d.), 'General government gross debt – % of GDP and million EUR'. https://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&spcode=sdg_17_40&plugin=1

2000
2010

Cypriot economy suffers from continuous deterioration in competitiveness caused by growing unit labour costs and reflected in widening current account deficits and lagging exports. From 2005, banking sector expands rapidly, creating vulnerabilities.

2008

1 January

Cyprus adopts the euro.

2010

16 November

Standard & Poor's downgrade: A from A+, the first in a series of downgrades resulting in the 2012 loss of investment grade.

2011

16 December

Parliament adopts measures to reduce the government deficit to 2.5% of GDP in 2012 from 6.3% of GDP in 2011.

23 December

Government agrees €2.5 billion loan from Russia.

2012

9 March

Greece conducts €199 billion sovereign debt restructuring (private sector involvement), triggering privately held Greek debt losses of over 22% of GDP in Cyprus.

21 May

Cyprus adopts legislation allowing it to underwrite Laiki Bank's €1.8 billion capital increase, in effect committing to purchase any shares not bought by private investors.

25 June

Request is made for financial assistance from the EFSF but negotiations make little progress ahead of national presidential elections.

30 June

Having failed to attract sufficient private investment, government rescues Laiki Bank, making the €1.8 billion share purchase, for an 84% holding in the bank.

Late September

The ratio of non-performing loans in Cypriot banks' Greek operations worsens to 42% of total loans, worth €19 billion (111% of GDP).

2013

24 February

Nicos Anastasiades is elected president. Negotiations over aid programme resume.

16 March

Eurogroup reaches an initial accord with Cyprus on aid package.

18 March

Fears of a bank run cause the Central Bank of Cyprus to declare a bank holiday, extended until 28 March.

19 March

Parliament rejects the aid agreement.

25 March

Eurogroup approves a revised package. Under the new terms, the burden is shifted to depositors with holdings over €100,000.

28 March

Capital controls are imposed, would be lifted two years later.

12 April

Eurogroup says agreement reached on the conditions of the €10 billion ESM/IMF financial assistance for Cyprus, in line with 25 March package, subject to the IMF's contribution.

13 May

ESM disburses part of the first loan tranche (€2 billion).

2014

18 June

Cyprus returns to international capital markets with a 5-year bond sale, raising €750 million.

2016

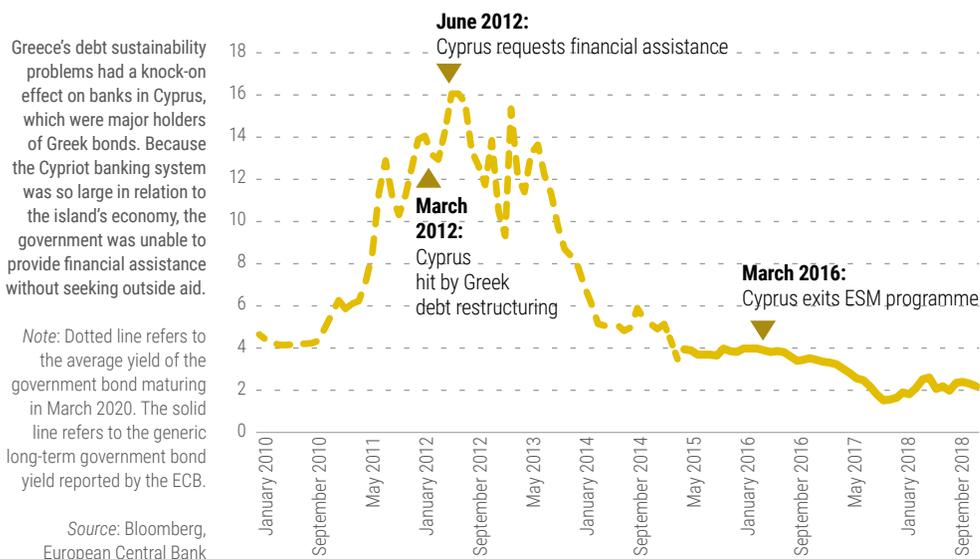
31 March

Cyprus successfully exits ESM financial assistance programme.

While harbouring reservations about the stigma and short-term economic hardship of an aid package, the government, headed by a communist president, formally sought a full macroeconomic adjustment programme with the EFSF on 25 June 2012 – the same day as Spain – but Cypriot pursuit of minimal conditions got in the way of a rapid agreement²⁷⁶.

Government bond yield – Cyprus

in %, monthly frequency



According to Michael Sarris, who would become finance minister for a short period after early 2013 elections, talks between Cyprus and what was then the troika of aid institutions focused on small issues instead of how to move forward. ‘We spent six months discussing things like a cost of living adjustment clause that the donors wanted to discontinue,’ Sarris said, describing talks in the second half of 2012. ‘In other words, details while the house was on fire.’

²⁷⁶ Statement by the president of the Eurogroup, 25 June 2012.

http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/131195.pdf

An agreement on conditions seemed close in November 2012, by which time the ESM was up and running. Juncker, then the outgoing president of the Eurogroup, said in early December that Cyprus was already taking the first steps to implement the draft agreement and he looked forward to its conclusion soon²⁷⁷. But by January 2013, talks had stalled. At its last meeting under Juncker, the Eurogroup announced that the programme would be delayed²⁷⁸.

Discussions didn't pick up speed until February 2013, when Nicos Anastasiades was elected president on a centrist platform²⁷⁹.

When euro area finance ministers met on 4 March 2013, an accord appeared within reach. Now the Cypriot minister, Sarris outlined the government's policy intentions. A post-Eurogroup statement praised the 'useful' presentation, looked ahead to the 'swift conclusion' of the negotiations, and pencilled in the end of March as the target for the political signoff on the programme²⁸⁰.

That deadline would be met, but not in the way the Eurogroup envisaged. The final push was marked by political brinkmanship, Cypriot parliamentary opposition, the floating of Plan Bs, questions about Cyprus's euro adherence, overtures to Moscow, and an extended bank holiday that left the 866,000-strong Cypriot population fearful for the future.

In hindsight, a Cypriot programme was inevitable.

'The Cypriot government put us in a difficult spot by repeatedly refusing to apply for a programme,' said Wieser, Eurogroup Working Group chairman during the crisis. 'They would have got off considerably cheaper, easier, and better if they had applied for a programme half a year earlier, or even a year earlier, as they should have.'

²⁷⁷ Statement by the president of the Eurogroup, 3 December 2012.

https://www.eerstekamer.nl/eu/overig/20121210/statement_by_the_president_of_the_document

²⁷⁸ European Commission (2013), 'Speech: Vice-President Rehn's remarks at the Eurogroup press conference', 21 January 2013. http://europa.eu/rapid/press-release_SPEECH-13-41_en.htm

²⁷⁹ Cyprus, Ministry of the Interior (2013), 'Presidential run-off elections 2013: Official results', February 2013. http://results.elections.moi.gov.cy/English/PRESIDENTIAL__EPANALIPTIKI_EKLOGI_ELECTIONS_2013/Islandwide

²⁸⁰ Eurogroup statement on Cyprus, 4 March 2013.

http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/135809.pdf

What made Cyprus different from previous programme countries was the size and skewed nature of its financial sector. Bank assets were 657% of GDP in 2012. Non-performing loans were high and would eventually reach around 50% of the loan book. Along with ordinary struggling borrowers, Cyprus had a class of strategic defaulters, who could pay but didn't feel obliged to. 'The legal framework was very debtor-friendly – if you didn't pay your loan, the bank couldn't do anything,' said Sutt, then the ESM's Cyprus mission chief. The haircut on Greek bonds exposed the system's fragility.

Cyprus had tried to fix the problem on its own in May 2012, with an effort to bring in new capital of €1.8 billion for Cyprus Popular Bank, known as Laiki Bank²⁸¹. In June, it became clear that Cyprus couldn't raise the money privately so the government would need to provide the rest of the funds. The state aid was necessary because the bank had fallen short of meeting its minimum regulatory capital requirements as determined by the European Banking Authority, which in 2011 had started stress-testing banks across the EU.

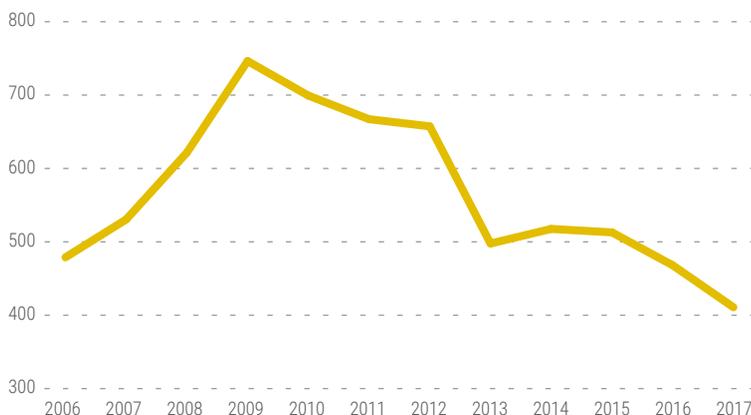
In all, Cypriot banks were staring at a €8.9 billion shortfall in their balance sheets under an 'adverse scenario', according to an independent analysis that was conducted by the investment management firm PIMCO in late 2012²⁸².

²⁸¹ Cyprus, Central Bank of Cyprus (2013), 'Rescue programme for Laiki Bank', Announcement, 30 March 2013. <https://www.centralbank.cy/en/announcements/30-03-2013>; European Commission (2012), 'State aid: Commission temporarily approves rescue recapitalisation of Cyprus Popular Bank', Press release, 13 September 2012. http://europa.eu/rapid/press-release_IP-12-958_en.htm

²⁸² PIMCO (2013), 'Independent due diligence of the banking system of Cyprus', PIMCO Europe Ltd, London, March 2013. <https://ftalphaville-cdn.ft.com/wp-content/uploads/2013/04/reportasws.pdf>

Total bank assets – Cyprus

in % of GDP



Banks represented an outsized proportion of the Cypriot economy, rendering it unusually vulnerable to difficulties in the sector.

Note: GDP is not seasonally adjusted in this chart.

Source: European Central Bank, Eurostat

The problems ran deeper than the banks. The European Commission had identified ‘very serious macroeconomic imbalances’ in the Cypriot economy, extending to the trade balance and public finances²⁸³. It called for ‘urgent economic policy attention in order to avert any adverse effects on the functioning of the economy and of Economic and Monetary Union,’ according to an in-depth review. In other words, Cyprus was seen as potentially systemic, bearing a risk of spillovers to the rest of the euro area.

This tangle of fiscal, financial, and economic deficiencies formed the backdrop for the last act in talks that would make Cyprus the fifth euro member state to receive emergency assistance. The institutions had concluded that Cyprus would need €10 billion for the banks²⁸⁴, plus roughly €7 billion for general government financing²⁸⁵. But this €17 billion total was about the size of Cypriot GDP. The IMF warned

²⁸³ European Commission (2012), ‘Following in-depth reviews, Commission calls on Member States to tackle macroeconomic imbalances’, Memo, 30 May 2012. http://europa.eu/rapid/press-release_MEMO-12-388_en.htm

²⁸⁴ Reuters (2012), ‘Cyprus bailout eyes up to 10 billion euros for banks: Central bank’, 30 November 2012. <https://www.reuters.com/article/us-cyprus-bailout-banks/cyprus-bailout-eyes-up-to-10-billion-euros-for-banks-central-bank-idUSBRE8AT01220121130>

²⁸⁵ European Commission, Directorate-General for Economic and Financial Affairs (2013), ‘The Economic Adjustment Programme for Cyprus’, *European Economy Occasional Papers* 149, May 2013. http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/pdf/ocp149_en.pdf

that lending on that scale would render Cyprus's debt completely unsustainable. To design a programme in which the debt could be sustainable, the Eurogroup settled on up to €10 billion in aid.

The IMF and several northern European countries pressed Cyprus to bail in bank creditors, Sarris said, to ensure that investors, debt holders – and ultimately depositors, because of the way the banks were structured – would absorb a share of the losses to cover the capital shortfall. Meanwhile, Cyprus was running out of time. Following its internal rules, the ECB was poised to cut off the Cypriot banks from their last lifeline, Eurosystem emergency liquidity assistance.

Matters came to a head at a Eurogroup meeting on 15 March 2013. Sarris went into the session under no illusions about Cyprus's leverage. 'We really had no negotiating power and no credibility,' he said. With the ECB threatening to withdraw the emergency liquidity, Cyprus was faced with the choice of applying for a programme or abandoning the euro. 'Basically, they were telling us, "Your banks would have to close,"' Sarris recalled. 'And they actually said, in so many words, that they couldn't reopen.'

Cyprus's banks were not only distinguished by their economic heft. For financing, they sold relatively few bonds, putting greater reliance on foreign depositors. As a last-ditch way to spread the pain as widely as possible, Cyprus ended up proposing a 6.75% levy on all deposits – essentially a wealth tax on everyone with a bank account²⁸⁶.

Crucially, this tax would not exempt account holders covered by EU-wide deposit insurance guidelines, which were instituted in 1994 and updated in 2009 and 2010 in order to prevent bank runs and reinforce confidence in the banking system. By the time of the 2013 Cyprus aid negotiations, deposits were insured up to €100,000. Cypriot officials presented the tax as a one-off levy of 18 months of interest, since Cypriot bank accounts were returning 5% a year.

The measures being asked of Cyprus were more drastic than anything bank customers had endured in modern times. 'But obviously that didn't change the numbers,' Sutt said.

²⁸⁶ *Economist* (2013), 'The Cyprus bail-in – A bungled bank raid', 23 March 2013. <https://www.economist.com/finance-and-economics/2013/03/23/a-bungled-bank-raid>

In the early hours of 16 March, the Eurogroup agreed to provide up to €10 billion to Cyprus in exchange for the downsizing of the banking system, the modernisation of the financial supervisory framework, the tightening of the government’s budget, and steps to fight money laundering. A Eurogroup statement welcomed the ‘ambitious measures to ensure the stability of the financial sector’²⁸⁷.

Cypriots woke up to the news that they would have less in the bank than they thought, while financial markets weighed the implications of the Eurogroup entering into the uncharted territory of forcing losses on insured depositors. When the securities exchanges opened on Monday, fears of contagion made the rounds again, with bank shares hit by concern that the Cypriot deposit tax would become a new, regularly used tool in the euro area’s arsenal and make promises of deposit insurance moot.

‘European bank shares fell more than 2% on Monday as a plan by Cyprus to seize money from bank deposits raised fears that savers elsewhere may not be safe and the euro zone may be plunged back into crisis,’ Reuters wrote on 18 March²⁸⁸. It was a reminder of how, thanks to the interconnected financial system, an island economy accounting for less than 0.2% of euro area GDP could touch off a larger crisis.

Back in Cyprus, the banks were closed and politicians up in arms over the tax on small depositors. On Tuesday, the parliament voted to reject the plan, without a single lawmaker in favour²⁸⁹. Cyprus again looked to Russia as a potential saviour. Russia had disbursed €2.5 billion to Cyprus in three tranches in 2011 and 2012, but Sarris came back empty-handed from a March 2013 trip²⁹⁰. Russia did

²⁸⁷ Statement by the Eurogroup on Cyprus, 16 March 2013.

https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/136190.pdf

²⁸⁸ Reuters (2013), ‘European bank stocks drop on Cyprus contagion fear’, 18 March 2013.

<https://uk.reuters.com/article/us-eurozone-cyprus-banks-idUKBRE92HOET20130318>

²⁸⁹ Reuters (2013), ‘Cyprus lawmakers reject bank tax; bailout in disarray’, 19 March 2013.

<https://www.reuters.com/article/us-cyprus-parliament/cyprus-lawmakers-reject-bank-tax-bailout-in-disarray-idUSBRE92G03I20130319?feedType=RSS>;

Bloomberg (2013), ‘Cyprus loan request spurned by Russia in Moscow: Sarris’, 21 March 2013.

<https://www.bloomberg.com/news/articles/2013-03-21/cyprus-said-to-look-for-5-billion-euro-russian-loan-in-moscow>

²⁹⁰ Reuters (2013), ‘Cyprus seeks Russia investment, loan extension: Finance minister’, 21 March 2013.

<https://www.reuters.com/article/us-eurozone-russia-sarris/cyprus-seeks-russia-investment-loan-extension-finance-minister-idUSBRE92K09220130321>

eventually restructure its existing loans to Cyprus so they would have a longer repayment period and lower interest rates, but only after a euro area package was agreed²⁹¹.

Lawmakers in Nicosia considered alternatives to the across the board bank account levy, eventually settling on a plan that spared insured deposits and shifted the burden to those holding more than €100,000. Cyprus maintained the pledges to overhaul its economy and downsize its banking sector²⁹². What mattered for the Eurogroup was that the fiscal maths still worked, paving the way for a decisive policy meeting. On 25 March 2013, euro area finance ministers endorsed the revised package, with up to €10 billion in assistance during a three-year adjustment programme. It was the first full ESM programme, embracing public finance as well as banking components.

On 28 March, Cyprus imposed capital controls and began to deal with the fallout from its decisions. The agreement was finalised on 2 April. The ESM signed off on 24 April²⁹³ on the European commitment, which would eventually be €9 billion. The IMF announced on 15 May that it would contribute €1 billion, participating on a much smaller scale than it had in past European aid packages²⁹⁴.

IMF Managing Director Lagarde gave the Cypriot government credit for taking ownership of the programme, likening its commitment to that of Ireland. She praised Anastasiades for his ability to rally support at crucial moments. 'I remember a discussion with the president, talking to colleagues and saying, you know, stop questioning, just get on and do it,' Lagarde said.

As part of the agreement, Cypriot banks sold their Greek branches to Piraeus Bank ahead of the capital controls, ensuring those offices could reopen and Greek depositors wouldn't be touched by the limits imposed. The capital controls won the cautious blessing of the euro

²⁹¹ European Commission, Directorate-General for Economic and Financial Affairs (2013), 'The Economic Adjustment Programme for Cyprus', *European Economy Occasional Papers* 149, p. 107, May 2013.

²⁹² Eurogroup statement on Cyprus, 25 March 2013.
http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/136487.pdf

²⁹³ ESM (2013), 'ESM Board of Governors grants stability support to Cyprus', Press release, 24 April 2013.
<https://www.esm.europa.eu/press-releases/esm-board-governors-grants-stability-support-cyprus>

²⁹⁴ IMF (2013), 'IMF executive board approves €1 billion arrangement under extended fund facility for Cyprus', Press release, 15 May 2013.
<http://www.imf.org/en/News/Articles/2015/09/14/01/49/pr13175>

area, because of the ‘unique and exceptional situation of Cyprus’s financial sector and to allow for a swift reopening of the banks’²⁹⁵. As long as the measures were temporary, proportionate and non-discriminatory, in line with EU treaties, they could go ahead.

Cyprus even managed to restructure some of its government debt as part of efforts to get its financial picture under control. In June 2013, it swapped some of its local bonds for longer-term bonds in a bid to ease immediate liquidity pressures. The move put Cyprus briefly into ‘selective default’ from a credit rating standpoint, as analysts at Standard & Poor’s judged the new bonds to be on less favourable terms for Cyprus’s investors²⁹⁶.

Although it upset markets at the time, the Cyprus solution was also a game changer in bank resolution. The notion of an upfront bail-in of all bank creditors, including senior creditors if necessary, was not yet customary in the EU and only junior creditors had previously been required to take losses. The Cypriot programme was in its first year when, in December 2013, the European Parliament and representatives of national governments struck an agreement on the bank recovery and resolution directive²⁹⁷, which spells out how investors are in line to take losses when a bank fails. The move to tap senior bank creditors in Cyprus was part of significant changes in the banking landscape²⁹⁸.

Today it is clear that the Cypriot programme set a new precedent for handling a large and troubled banking sector by de-emphasising the taxpayer-funded rescues that had been the traditional approach in Europe and elsewhere. In Spain, junior bondholders took losses but

²⁹⁵ Eurogroup statement on Cyprus, Statement, 25 March 2013.

http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/136487.pdf

²⁹⁶ S&P Global (2013), ‘Research update: Cyprus ratings lowered to “SD” following announced exchange offer on several local law bonds’, 28 June 2013.

https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/8086197

²⁹⁷ European Parliament (2013), ‘Deal reached on bank “bail-in directive”’, Press release, 12 December 2013. <http://www.europarl.europa.eu/news/en/press-room/20131212IPR30702/deal-reached-on-bank-bail-in-directive>

²⁹⁸ ‘Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council text with EEA relevance’, OJ L173/190, 12 June 2014.

<https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059>

senior creditors were spared. However, in Cyprus, the banks had little junior debt and the numbers didn't add up unless senior creditors contributed.

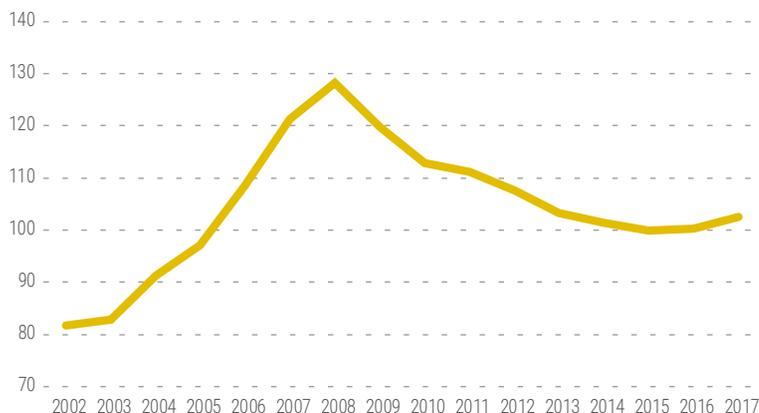
The ESM was still an embryonic organisation, sending a two-or three-person team to the Cyprus talks. While outnumbered by representatives of the other institutions, the ESM delegation brought a mix of public and private sector experience, as well as a broad spectrum of understanding of the connections between banks, finance, and the debt repayment profile.

It helped that the ESM had established itself based on its work in other countries. This created a virtuous circle: because the ESM had gained respect from its work with the other institutions and local authorities, it received better cooperation from its partners. And, with the additional information that close cooperation can provide, its own contributions improved further.

'With the ESM in the picture, the institutional roles changed and that facilitated the access,' said ESM Chief Economist Strauch. 'It worked relatively well in Cyprus, pretty much from the start.'

House price index – Cyprus

(2015=100)



A house-price collapse compounded Cyprus's woes.

Source: Eurostat

Cyprus tackled the task of whittling away at the rapidly accumulating debt. Once Cyprus was carrying out its programme, real house prices rose, a sign that homeowners were benefiting from the economic reforms. Its debt-to-GDP ratio peaked at 107.5%, a better outcome than expected, and the country progressed in overhauling its banks.

Fresh capital for banks, some of which came from the aid programme, brought a first glimmer of confidence. However, some of the efforts to stabilise the financial sector have proven tricky. The programme included €1.5 billion in capital to the country’s Cooperative Central Bank, but the bank later required another infusion of state aid after an ECB review found it wasn’t doing enough to manage non-performing loans²⁹⁹. The cooperative bank then came under increased scrutiny until 2018, when it was split up³⁰⁰. Parts of the bank were sold to a domestic competitor, while in particular the non-performing loans remained in a state-owned asset management company.

In the end, the capital controls did less damage than expected, because their implementation varied across different types of transactions in an attempt to minimise payment system disruptions and ensure the execution of transactions essential for the real economy³⁰¹.

‘One of the reasons why the capital controls did not disrupt the economy was that the programme included an efficient roadmap to remove them step by step once clear milestones in the programme were reached,’ said Paolo Fioretti, the ESM’s country coordinator for Cyprus. ‘A clear time horizon increased the commitment of the government in implementing related necessary measures and gave people more confidence that the controls would be transitory.’

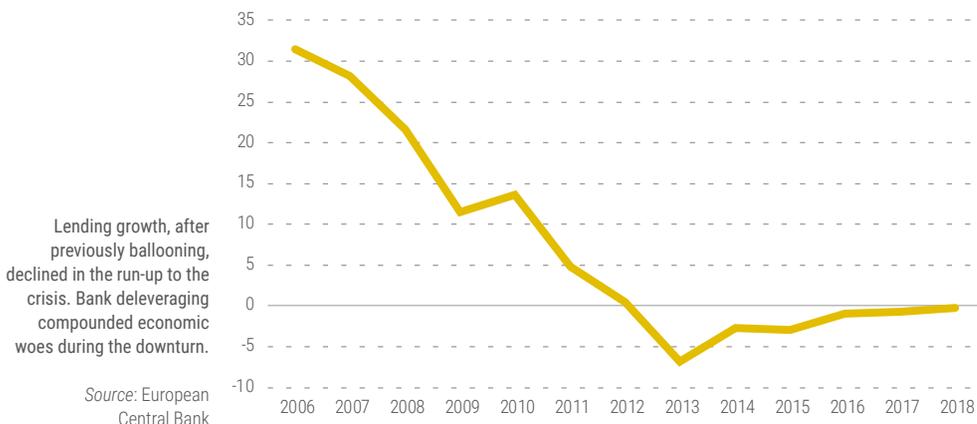
²⁹⁹ European Commission (2015), ‘State aid: Commission approves additional aid for Cypriot cooperative banks on the basis of an amended restructuring plan’, Press release, 18 December 2015. http://europa.eu/rapid/press-release_IP-15-6365_en.htm

³⁰⁰ Central Bank of Cyprus (2018), ‘Withdrawal of licence of Cyprus Cooperative Bank’, 5 September 2018. <https://www.centralbank.cy/en/announcements/withdrawal-of-licence-of-cyprus-cooperative-bank>

³⁰¹ IMF (2013), ‘Cyprus: Letter of intent, memorandum of economic and financial policies, and technical memorandum of understanding’, p. 3, 29 April 2013. <https://www.imf.org/external/np/loi/2013/cyp/042913.pdf>

Lending growth for house purchases – Cyprus

annual % change



Overall, the programme strengthened the banks while also reining them in. 'In the end, the banking sector benefited too,' said Sutt, a veteran of the IMF and the Estonian Central Bank. Cyprus Popular Bank was shut when its troubles became too big to fix. Meanwhile, the largest Cypriot bank became de facto foreign controlled, as did the third largest, bringing new incentives for the banks to improve governance, work better with the government, and lend in a way that helps the overall economy. 'The shareholder structure changed dramatically. It helped to change the governance and the links between the banks and the entrepreneurs, and the politics,' Sutt said. 'In the end, I think it's a positive for a country. But these exercises are, at the time, never easy in terms of implementation.'

The programme in Cyprus benefited from strong cooperation with local authorities, once it was finally underway. 'In March of 2013, Cyprus was in a difficult position. Most of the adjustment efforts had to come from the Cypriot population. Now, we see that the approach has brought good results,' Fioretti said.

Cyprus lifted all external capital controls on 6 April 2015³⁰². In March 2016, Cyprus exited its programme on schedule, although it chose to leave €2.7 billion of the initial envelope unspent – in part

³⁰² European Commission (2015), 'The Economic Adjustment Programme, Cyprus: 6th Review – spring 2015', *European Economy Institutional Papers* 004, p. 23, Spring 2015. https://ec.europa.eu/info/sites/info/files/file_import/ip007_en_2.pdf



Eurogroup President Jeroen Dijsselbloem gestures to ESM Managing Director Klaus Regling (with back to camera) as Cypriot Finance Minister Harris Georgiades looks on at the 7 March 2016 Eurogroup meeting in Brussels. Cyprus successfully completed its loan programme three weeks later.

Credit: European Union

because it was unable to meet a few of its last programme conditions by the time of the exit, and in part because financing needs turned out to be lower than initially estimated.

Cypriot programme (2013–2016)

- **Initial programme amount:** €10 billion
- **Total amount disbursed:** €7.3 billion, of which the ESM provided €6.3 billion
- **Lenders:** ESM, IMF
- **Final weighted average maturity (ESM loans):** 14.9 years
- **Key legislated reforms:** wage policies; foreclosure and bankruptcy laws; restructuring and downsizing of financial institutions; fiscal consolidation; structural reforms (public administration, services)

‘Cyprus has managed to restore economic growth and repair public finances much faster than expected,’ said Juncker, now the Commission president. ‘Overall, the experience in Cyprus confirms what we have seen in other programme countries: the strategy of providing loans to a country in a deep crisis in exchange for economic policy reforms is one that works.’

Clean exit: Portugal wraps up its programme

32

We decided that having a precautionary programme was not needed. Even in hindsight, I still think it was a good decision.

Maria Luís Albuquerque

Portuguese Finance Minister (July 2013–November 2015)

The ESM proved its mettle in setting up the assistance programme for Cyprus, building on its success in providing bank-focused aid to Spain. One of the next challenges would be not just how to start a rescue programme, but how to help countries cement their recovery.

In late 2013 and early 2014, EFSF programmes in both Ireland and Portugal were coming to a close. Ireland's economy had bounced back strongly and, by mid-2012, financial markets were willing to lend again without a euro area safety net. Portugal's outlook was less certain. It began syndicated sales to banks in 2013, but its auction debut would have to wait until April 2014³⁰³. The successful €750 million return to markets was seen as evidence that Portugal would be able to exit its

³⁰³ For a fuller assessment of how four programme countries approached the restoration of market access, see Strauch, R., Rojas, J., O'Connor, F., Casalinho, C., de Ramón-Lapa Clausen, P., Kaloziis, P. (2016). *Accessing sovereign markets: The recent experiences of Ireland, Portugal, Spain, and Cyprus*, ESM, Discussion Paper 2, 20 June 2016.
<https://www.esm.europa.eu/sites/default/files/esmdp2final.pdf>

2013

23 January

Portugal returns to international capital markets with a syndicated tap, raising €2.5 billion.

June

Seventh review of Portuguese programme published after months of delay.

1 July

Internal government disagreements prompt resignation of Finance Minister Vítor Gaspar.

2014

28 April

The EFSF makes what turns out to be the final loan disbursement. (€1.2 billion)

2 May

Positive twelfth review, aiming to conclude with a final June disbursement. Court blocks a key reform – review ended, no disbursement.

5 May

The European Commission takes note of Portugal's decision not to seek precautionary aid programme.

18 May

Portugal successfully exits EFSF financial assistance programme.



IMF Managing Director Christine Lagarde (left) speaks with Portuguese Finance Minister Maria Luísa Albuquerque (right) prior to the start of the Eurogroup meeting on 8 July 2013 in Brussels, just after Ms. Albuquerque took office. Eurogroup Working Group Chairman Thomas Wieser is in the centre.

Credit: Thierry Charlier/AFP

EFSF programme, but at that time markets questioned if it should keep some sort of lifeline open to the firewalls.

Of all of the ESM's new tools, the precautionary credit line was the one that seemed most useful for Portugal given the circumstances. Modelled after similar arrangements offered by the IMF, the tool was designed to help countries maintain or restore market access without taking on new loans and a whole new programme. By agreeing to a set of economic policies and monitoring protocols, countries could have access to a credit line that would ensure they would not run out of money overnight. In turn, the very existence of that credit line would encourage markets to keep lending, ideally allowing the aid money to remain untapped. The idea was that this process would create a virtuous circle of momentum, and then they would not need a full financial assistance programme again.

The main argument for taking a precautionary credit line was that it would reassure markets that Portugal wasn't on the brink of running out of cash, allowing an easier transition back to market financing. On the other hand, it would paint Portugal in a different light from Ireland, which didn't need one. In addition, should Portugal decide to request aid, it would have to negotiate a new round of conditions with its euro area peers and then get those conditions through its national parliament.

ESM Chief Economist Strauch said Portugal's conundrum and eventual decision to go it alone were a product of the political and financial conditions of the time. 'They could get back to the market. They could finance themselves, but it would have been very useful to keep a bit more pressure on them to continue the reforms. That incentive was lost,' Strauch said. 'The Irish, by creating the clean exit as the role model, meant the Portuguese had to go towards a clean exit. We just had to see how it went.'

In 2013, although relations with the troika of international institutions were good, public resentment in Portugal was brewing and political ownership of the programme – and its conditionality – was slipping. 'As the recession went on too long and the social uproar against austerity policies became stronger, formally supported by the decisions of the constitutional court, the government became more reluctant to assume ownership of the programme and slowed the structural reform momentum,' said Teixeira dos Santos, former Portuguese finance minister.

The programme's seventh review, in 2013, foreshadowed troubles ahead³⁰⁴. That review dragged on for three months, a long time by Portuguese programme standards. It was marked by internal government disagreements, leading up to the July 2013 resignation of the finance minister, Gaspar, as well as increasingly drawn-out negotiations with the troika. Tax reforms, in particular, put a strain on workers, which 'created a political problem and then the ownership of the programme deteriorated,' Strauch said.

As relations broke down, Portugal took a different view from the euro area institutions on whether or not it should apply for a precautionary programme to ease its return to market access. At the time, Teixeira dos Santos, whose government lost the elections shortly after the programme's start in May 2011, said he favoured a precautionary instrument because 'Portugal would have been more protected.' In hindsight, he says he is glad that 'market developments were positive and there was no need for it.'

³⁰⁴ European Commission, Directorate-General for Economic and Financial Affairs (2013), 'The Economic Adjustment Programme for Portugal: Seventh review – winter 2012/2013', *European Economy Occasional Papers* 153, June 2013.
http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/pdf/ocp153_en.pdf

Albuquerque, who took over as finance minister from Gaspar, defends Portugal's decision not to use it. In her view, the country's progress on meeting targets during the programme, restoring credibility, and regaining market access meant the country had more options as its assistance period ended.

Even several years on, she still believes it was a good decision to hold back from another programme. 'A follow-up or precautionary programme can be very important if market access is fragile,' she said. 'On the other hand, if you can complete the programme like Ireland did, like we did, having regained credibility and full market access, then the need for a precautionary or a follow-up programme is not obvious,' Albuquerque said. 'It's seen as a lack of confidence. There's a lot of psychology involved.'

There was also the question of whether or not the euro area partners wanted to authorise use of the new instrument. Misgivings included uncertainty about what new conditionality might entail, and how that might complicate internal deliberations, as well as questions about whether or not the benefits of such a short-term facility outweighed the negative signal its uptake would send to markets, according to the independent *EFSF/ESM financial assistance: Evaluation report* published in June 2017³⁰⁵.

Germany and other countries were against Portugal seeking a precautionary credit line, a view reinforced in 2016 by Germany's then-Finance Minister Schäuble. 'Portugal did not do so, and I thought it made the right decision,' he said. Nevertheless, he noted that progress on banking sector reforms and on bringing down high levels of corporate and public debt got harder after the programme ended. 'I am aware that post-programme surveillance became weaker without a precautionary credit line.'

Albuquerque disputes this. Portugal was already due for extra scrutiny as a result of its rescue package and adjustment programme. It faced a series of post-programme reviews and the EU's European semester process of national budget coordination. She says the precautionary programme would not have meant much change, and the government's decision against using it was not taken to avoid extra oversight.

³⁰⁵ Tumpel-Gugerell, G. (2017), *EFSF/ESM financial assistance: Evaluation report*, Publications Office, Luxembourg. https://www.esm.europa.eu/sites/default/files/ti_pubpdf_dw0616055enn_pdfweb_20170607111409.pdf

At the European Commission, officials held a much blunter assessment of Portugal's prospects for going it alone. 'With Portugal we had strong doubts that it would be wise to go out without a follow-up,' said the Commission's Buti. 'There was a devilish alliance between the country itself and the hardliners. Why? Because the country itself wants to declare victory and the hardliners, they don't want to push a precautionary programme through their parliament. Moral hazard and taking the jump without a parachute, this is a risk that could come back to haunt us.'

As the decision drew near, ESM officials joined the technical team of monitors and took a bigger role in working with country officials on the economic programme. This move reflected the institution's growing expertise and its role as one of Portugal's largest creditors.

From this front-line perspective, the firewall had a clear view of what was at stake as Portugal's decision approached.

'Since Ireland had already managed to exit the programme without any follow-up, treating or pushing Portugal too much not to follow the same approach would be extremely costly,' said Rojas, head of the ESM's economic and market analysis team, who also served as ESM country coordinator for Portugal. 'It was basically a political decision.'

Portugal did not have the same quality of ready market access that Ireland or Spain enjoyed. Rojas said this was in part because of how it traditionally sold its debt, through syndication that relied on a small group of would-be buyers. It was also generally more vulnerable to contagion when there was a crisis flare-up in Greece or elsewhere in the euro area. 'Portugal was borderline at the time,' Rojas said. 'In the case of Ireland, market access was decent. In the case of Portugal, it was less so.'

Even with the precautionary programme option now a distant memory, Portugal has remained more susceptible to financial market shockwaves than Ireland or Spain. Portugal's debt levels remain high and potential growth weak, burdened in part by a banking sector that is still recovering from the crisis. A government push to recapitalise banks helped the financial sector; however, banks remained a source of instability after the programme, in part because of weaker economic conditions, which reduced their asset quality and capital.

The reform efforts in Portugal had lost traction even before the programme ended, especially given a constitutional court decision requiring some public sector wage cuts to be rolled back. This made the ‘clean exit’ decision all the more difficult to digest for the monitoring institutions.

In the end, not only did Portugal not seek a precautionary aid programme, it even skipped its final IMF and EFSM disbursements because it never completed its last review. This came after its constitutional court overturned a law, without which it couldn’t meet the conditions necessary to unlock the aid. ‘At the end of the programme, I would have preferred if we had completed the last review as scheduled, instead of having it end through the lapse of time. I would have preferred a proper closure,’ Albuquerque said. The last EFSF disbursement that Portugal received came in April 2014.

The next milestone will come in a few years’ time, when Portugal begins to pay down its EFSF loan³⁰⁶. Following a full repayment of its IMF loan, Portugal has committed to do so earlier than expected³⁰⁷. It is currently under the ESM’s early warning system aegis, allowing the firewall to keep a close eye on its finances and economic management. A key test will be if the country is able to continue reducing its debt levels and managing the costs of rolling over its existing stocks of marketable debt.

‘In any case, things are looking brighter. We are at a more advanced stage now, where we can see the bigger picture, see how the economy and its banking system are recovering and what this means for its capacity to repay,’ said Sušec, the ESM’s deputy head of strategy and institutional relations, who also serves as mission chief in Portugal. In that context, the significant reduction in the fiscal deficit has been very encouraging.

‘Portugal has made great progress in restoring its public finances and fixing its banking sector. One of the issues which we still follow closely is the high level of sovereign debt, which makes the country vulnerable to sudden changes in market conditions.’

³⁰⁶ European Commission (n.d.), ‘Financial assistance to Portugal.’ https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-financial-assistance/which-eu-countries-have-received-assistance/financial-assistance-portugal_en

³⁰⁷ EFSF (2018), ‘EFSF approves waiver of Portugal’s mandatory repayment of EFSF loans’, Press release, 4 December 2018. <https://www.esm.europa.eu/press-releases/efsf-approves-waiver-portugal-s-mandatory-repayment-efsf-loans>

Ensuring repayment: the ESM's early warning system

33

The ESM does more than just finance rescue loans. With its early warning system, it monitors former programme countries' capacity to pay back their loans as agreed.

Klaus Regling

ESM Managing Director and EFSF Chief Executive Officer

Just as a private sector lender keeps tabs on the financial health of the borrower throughout the duration of the loan, the ESM needs to pay close attention to the balance sheets of the countries it assists. That is why governments mandated in the 2012 founding ESM Treaty that the fund 'shall establish an appropriate warning system to ensure that it receives any repayments due by the ESM Member under the stability support in a timely manner'³⁰⁸.

An early warning system procedure was approved by the ESM Board on 24 March 2014, after a 9 December 2013 Eurogroup decision to apply the system to EFSF loans as well. It requires the ESM to continuously track former programme countries' cash flow, ability to borrow on the open market, medium- to long-term sustainability of public debt, and banking system risks. This monitoring complements

³⁰⁸ Treaty Establishing the European Stability Mechanism, 2 February 2012.
https://www.esm.europa.eu/sites/default/files/20150203_-_esm_treaty_-_en.pdf

the fiscal and debt sustainability analyses of the European Commission and ECB, with the ESM concentrating on the loan repayment outlook.

‘It’s like with a bank – when the bank considers giving you a mortgage it must assess the ability of the borrower to repay the loan,’ said Rojas, the ESM’s head of economic and market analysis. The only difference is that the ESM’s monitoring is ongoing. ‘This is basically our tool to make sure that countries repay.’

Under the EU Treaty, the Commission and national government representatives are responsible for post-programme surveillance of countries that receive aid. However, the ESM needs a monitoring role to keep watch over repayment prospects and make sure recipient countries can fulfil their responsibilities in a timely manner. After all, if a country were to miss a scheduled payment, it could call into question the ESM’s ability to act in a future crisis by affecting the firewall’s financial capacity and creditworthiness. The ESM must maintain its fiduciary duty to its Members and bondholders.

To flag any potential repayment problems, the ESM continuously tracks the due dates for interest, fees, and principal repayments at least 12 months in advance. At the same time, it looks a year ahead at each country’s budget and economic outlook, taking the Commission’s analysis into account. On a quarterly basis, former programme countries provide a cash flow overview that indicates how payments will be made.

‘Looking at the budget and economic outlook always means looking at policies, but it does not mean that we will in any sense negotiate policies,’ said ESM Managing Director Regling. ‘We only have to monitor and make sure no problems show up.’

The task will keep the fund busy long after most current employees have moved on: ESM guidelines require it to carry out repayment risk assessments under the early warning system until loans are fully repaid, which will be into 2070 in the case of Greece. In contrast, the Commission’s euro area post-programme surveillance of economic and fiscal policy ends after 75% of the loan is paid back.

If the ESM’s internal risk committee determines that there might be doubt on a timely repayment that could lead to a payment default to the ESM, it would then escalate the oversight process. In that event, the ESM would consult with the Commission and the ECB to assess the

situation and its potential consequences in more depth. As a further escalation, the ESM would inform its Members, through the Board of Directors, of the repayment risk. Talks would take place immediately on a confidential basis.

To be sure, the ESM’s diversified funding strategy would help protect the firewall in the event of a delayed or missed payment. The rescue fund has flexible timing and instruments to ensure it always stays liquid.

A practical example of how the early warning system functions can be found in Ireland. In an important sense, the EFSF’s first client has been an unqualified success story, showing that a country can turn its fortunes around quickly if it commits to reforming its economy.

At the same time, Ireland can’t let down its vigilance. The post-programme assessment³⁰⁹, published in February 2018, found downside risks to the economy, particularly due to the uncertain effect of the UK’s decision to pull out of the EU. While welcoming the near-elimination of the deficit and early repayment of bilateral loans from Denmark, Sweden, and the IMF, the report urged the Irish authorities to work harder to boost the ‘shock resilience’ of public finances. Overall, however, it concluded that, thanks to improved debt sustainability and other factors, the risks for Ireland’s capacity to service its EFSF and ESM debt ‘remain low’.

That sort of intelligence isn’t obtainable only by sifting through economic data back in Luxembourg. To gain a nuanced, first-hand impression of the state of a country’s economy and government finances, the ESM needs experts who can be on the ground.

As with many ESM tools, the early warning system has been adapted and updated as the firewall gained experience. Originally, due diligence analyses were staggered according to each country’s repayment schedule. But varying dates for repayment led some countries to be examined more often than others. Portugal’s repayments were spread over the year, leading to frequent assessments, whereas Spain made only one payment a year, in December. ‘So, in the case of Spain, we were monitoring the repayment capability less often,’ Rojas said. ‘This is risky because, if something happens outside of this time period,

³⁰⁹ European Commission (2018), ‘Post-programme surveillance report: Ireland, autumn 2017’, *European Economy Institutional Paper 074*, Publications Office, Luxembourg, February 2018. https://ec.europa.eu/info/sites/info/files/economy-finance/ip074_en.pdf

then we could have a problem.’ As a result, the new policy provides for quarterly monitoring, regardless of payment due dates.

There was a similar logic to lengthening the time horizon of the early warning system assessment to a full 12 months from the five that were initially specified. It is thus no longer theoretically possible for a country to meet its December payment obligations and then run into trouble a few months later.

‘We didn’t want to take the risk of having a ripple after a repayment,’ Rojas said. ‘Even if a particular country doesn’t have to repay to us, the fact that a particular country defaults on some loans to other institutions, for instance, could trigger a default clause for our loans.’

Data-reporting standards also have been refined. At first, countries provided cash flow data in a variety of formats, sometimes lacking sufficient detail, making it hard for the ESM to obtain the complete picture. Now all use the same template. ‘One time, we got the projections in such a way that the information was almost completely irrelevant,’ Rojas said. ‘A goal of the new guidelines was also to send a message of, look, for something as fundamental as this, we must all take a standard professional approach.’

The changes were approved by the ESM Board of Directors on 18 March 2016.

The ESM worked closely with each country’s debt management office to identify which numbers it would need to see. Given the role of bank recapitalisation in aid programmes, the ESM also needed access to more banking data. The exposure of banks to sovereigns and vice versa means that troubles in the financial sector can have repercussions for national budgets. At first, some countries worried that their banking data could fall into the wrong hands, especially since they were still getting used to watching the ECB’s Single Supervisory Mechanism pore over the sector’s books, but the ESM was able to put safeguards in place to reassure them.

‘Banking issues are usually very delicate,’ Rojas said. ‘We were able to overcome these concerns by including in the new guidelines statements saying that the projections a country sends us can only be used for the risk assessment activities of the ESM, and that only those people involved in risk assessment activities can access the data.’



The first independent evaluation report of EFSF and ESM programmes made a series of recommendations, including on the early warning system’s effectiveness.

As much as possible, the ESM uses publicly available data. Only when a specific risk is identified does the ESM contact supervisors to drill deeper into the figures.

How will the early warning system evolve from here? A 2017 evaluation report³¹⁰, commissioned by the ESM Board of Governors, recommended a review of its effectiveness, noting that its ‘scope and enforcement power is limited’.

~ For more on the evaluation report, see Chapter 39.

‘The EWS relies on moral persuasion, peer pressure, and the powers of other institutions to achieve its purpose,’ the report found.

³¹⁰ Tumpel-Gugerell, G. (2017), *EFSF/ESM financial assistance: Evaluation report*, Publications Office, Luxembourg. https://www.esm.europa.eu/sites/default/files/ti_pubpdf_dw061605enn_pdfweb_20170607111409_1.pdf

In terms of its mission to monitor programme countries' ability to repay, the report said that the early warning system was 'adequate', but questioned what would happen if risks arose. It suggested that the system could do little to prevent a rollback or even reversal of reforms. Furthermore, it noted that the early warning system is 'limited to programme countries, which does not allow it to capture systemic risks.' One way to prevent future crises could be to expand the early warning system monitoring process beyond the countries that are paying back aid. This would involve changing the ESM's remit, and it would make it easier to combat the next crisis if problem spots are identified sooner.

The euro area is in the midst of shaping the future of its institutions. Towards the end of 2018, Member States agreed to broaden the mandate of the ESM beyond aid programmes while respecting the mandate of the European Commission related to surveillance and economic policy coordination.

‘Just in case’: the direct bank recapitalisation tool

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Our toolkit is sufficient for our core mandate. Even instruments like the direct recapitalisation instrument, which have never been used, are good to have just in case something goes terribly wrong.

Klaus Regling

ESM Managing Director and EFSF Chief Executive Officer

The euro area established a direct channel to banks – a major advance for the monetary union – when the ESM’s toolbox was expanded to include a direct recapitalisation instrument (DRI). First conceived in 2012, the DRI was seen as a way to prevent further crisis escalation in the event of a heavily indebted country having to take on more loans to save a systemically important bank.

At the time, there were few public avenues for stabilising a failing bank and little consensus on when and whether troubled financial firms should be propped up or shut down. Now the EU has clear rules for those contingencies, and the banking union features a Single Resolution Board, backed by its own resolution fund, with the power to dismantle a systemic bank safely.

When Europe’s crisis-fighting strategy was a work in progress, the development of the DRI served as reassurance for the banking system, especially between 2012 and 2014.

'At the time, it was really important to dispel or reduce the fears that Europe was unable to manage the crisis. For that, the instrument was useful. The probability of this instrument being used is now close to zero,' said Sutt, the ESM's head of banking from 2013 to 2016.

Had it been available at the time, direct recapitalisation could have suited Ireland, whose state bank guarantee led to a substantial spike in government debt, damaging the overall economy. The Irish experience, which came as exposure to US subprime debt was forcing governments in Germany, France, the UK, and elsewhere to prop up their banks, exploded market fears about linked bank-sovereign finances.

Nonetheless, it took more than two years – from a summit pledge in June 2012 until the last details were ironed out in December 2014 – for the euro area to declare the tool ready for ESM deployment. During that time, negotiations were shaped by the success of indirect ESM lending to stabilise Spain's banks and a broader shift in the European regulatory backdrop.

In the original 2012 commitment, euro area leaders had tied use of the DRI to a series of conditions, including compliance with the EU's state aid rules. By autumn 2012, those conditions took on more emphasis: at a 25 September meeting in Helsinki, the finance ministers of Germany, the Netherlands, and Finland stressed that the ESM would step in only 'as a last resort' and at a member state's request.

The first line of defence, the three ministers said in a statement³¹¹, would be bank shareholders and creditors and the budget of the member state concerned. ESM intervention, in other words, wouldn't take place overnight.

In their view, intervention was warranted for problems on a euro area scale, not to rectify the failures of national bank supervision. The statement clearly showed how difficult this kind of assistance was for some countries to accept.

'There was a great deal of discussion on the direct recapitalisation of banks. These proposals clashed with the reluctance of many to share risks,' said de Guindos, the Spanish finance minister through much of the crisis and now the vice president of the ECB.

³¹¹ Finland, Ministry of Finance (2012), 'Joint statement of the ministers of finance of Germany, the Netherlands and Finland', Press release, 25 September 2012.
https://vm.fi/en/article/-/asset_publisher/joint-statement-of-the-ministers-of-finance-of-germany-the-netherlands-and-finland

A key condition regarding the use of the DRI is that the bank concerned should be systemically important, rendering its rescue indispensable to safeguard the financial stability of the euro area. The European Commission would also have to judge that an ESM-backed recapitalisation and restructuring would restore the bank to viability.

Political agreement on the operational framework for direct ESM banking intervention was reached at a Eurogroup meeting in June 2014³¹². ‘It was hugely controversial among [the ESM] Members,’ Sutt said. ‘The conservative view was that this was too risky. From the southern part of Europe, the idea was “this is exactly what we need.”’

Finance ministers said the ESM could use up to €60 billion of its total capacity on the DRI. The actual drain on ESM resources, however, would be greater because the provision of direct financial assistance to distressed banks carries higher risks than lending to a cash-strapped government. Use of the tool would reduce the ESM’s lending capacity, possibly by as much as €180 billion off the ESM’s overall lending ceiling of €500 billion. However, by preventing further crisis escalation, the benefits were thought to outweigh this potential drain.

A government applying for a direct recapitalisation programme would have to show that it would be saddled with excessive debt if it borrowed from the ESM in order to pass the funds on to the troubled bank, as Spain had done. The purpose of the direct ESM injection is to bypass the government and avoid increasing its sovereign debt. While the Spanish example was a success story, it might have been trickier for a country whose debts were larger relative to the size of its economy.

The creation of the direct bank intervention tool marked the ESM’s biggest departure yet from the IMF’s crisis-lending model. With this new step, the euro area rescue fund took on duties similar to those performed by the European Bank for Reconstruction and Development or the World Bank’s International Finance Corporation.

‘Historically, we only lend money to sovereigns, as the IMF does. On the other hand, as a crisis-fighting institution it could make sense to go into the private sector like multilateral development banks.’ ESM Managing Director Regling said.

Following the political go-ahead from the Eurogroup, it fell to the ESM to draw up the operations manual for direct recapitalisations. Regling brought in David Vegara, a former deputy finance minister in Spain and

³¹² Statement by the president of the Eurogroup, 10 June 2014.
<https://www.consilium.europa.eu/media/28065/143163.pdf>

IMF veteran, as a senior advisor in September 2012. In December, Vegara moved to the Management Board and, alongside Frankel, became a deputy managing director, in recognition of the scope of his experience.

Vegara was tasked with overseeing the building up of an ESM team capable of managing large-scale bank holdings across Europe. At that time, it was clear that banking issues would be an increasingly central issue for the ESM and there was a clear need for Vegara's particular expertise.

'It's a huge amount of work. You're looking at taking on the management and oversight of a bank or even several banks,' Vegara said.

Thanks to Vegara's technical and management skills, the ESM was able to build its banking department from scratch and make sure it could be fully operational when needed. But, when the DRI became ready to use in December 2014, it also became clear that the tool would be unlikely to be deployed. Vegara moved back to his old role as special advisor before departing from the ESM in February 2015, his assignment complete.

The ESM's General Counsel, David Eatough, said: 'The idea is that you take the sovereign out of the credit equation, and rather than the sovereign owning the money and then lending it, you buy shares in the banks and directly recapitalise the banks. It would have been a massive change from anything the institution had done before.'

To wield the new instrument, the ESM needed staff expertise to assess whether a bank is viable or needs to be split and resolved, taking into account conditions in the relevant national banking market. ESM experts would have to master a given bank's valuation metrics and the due diligence required.

Besides recruiting public and private banking professionals, the ESM put together a project group drawn from across the organisation. It spent six months developing a clear understanding of how to assess, structure, and execute a transaction while maintaining the safeguards to underpin the ESM's high credit rating.

One of the additions was Mike Hesketh, hired from the European Bank for Reconstruction and Development and one of the ESM's principal banking experts. 'The concept of direct recapitalisation, putting a large equity investment into the viable part of a bankrupt systemic bank, was challenging,' Hesketh said. 'My role was to help develop the processes and internal procedures for how to assess risk, and how we could best structure it to mitigate that risk.'

The point wasn't to create a full-time bank-intervention department. The ESM decided that, in a crisis, it would supplement the core banking team with staff on secondment from other international financial institutions, and that it would hire consultants for detailed due diligence work.

It was also decided to create a subsidiary body within the ESM to carry out the bank recapitalisation. This format won out over using a special purpose vehicle under Luxembourg law, which had been considered earlier but did not pass legal muster.

Planning was also essential for the financial risks associated with bank shareholdings, given the potential for tremendous year-to-year volatility. For a conservatively managed institution such as the ESM, the prospect of losses or share markdowns would be a dramatic change.

‘What we could insist upon was that the costs we would incur, to arrange the funding and certain other costs, could be passed back to the beneficiary Member State,’ Hesketh said. ‘At least we wouldn't be incurring operational costs. But we would take the pure equity risk of the investment.’

Dealing with that risk would impose further limitations on the potential use of the tool. ESM Treaty rules could lead it to a call on Members to provide more capital if losses on equity holdings were to reach a certain limit – a controversial proposition.

As it issues bonds on the public markets, the ESM's need to provide regular transparency on its financial position also ruled out the use of deferred-loss accounting methods, which are common with nationally managed bank recapitalisation funds.

‘Let's assume that we make a loss on the equity holdings and that directly affects the ESM's equity,’ Hesketh said. ‘Then we're actually obliged to make a call to the shareholders. And, as Klaus memorably said: “That would be a painful call to make.”’

The new tool could not be deployed until the Single Supervisory Mechanism for euro area banks was up and running. Its debut took place on 4 November 2014³¹³. Shortly afterwards, in December 2014, the ESM

³¹³ ECB (2014), ‘ECB assumes responsibility for euro area banking supervision’, Press release, 4 November 2014. <https://www.ecb.europa.eu/press/pr/date/2014/html/pr141104.en.html>

declared the new instrument operational. By this time, however, the crisis had subsided and European bank regulation was moving on³¹⁴.

New rules for resolving troubled banks – the bank recovery and resolution directive – took effect at the start of 2015, although it would be another year before its creditor-loss hierarchy would be phased in. But the creditor-loss protocols kicked in immediately for any bank seeking ESM direct recapitalisation, giving member states another consideration to ponder.

In parallel, the euro area had equipped the ECB to become the common banking supervisor for systemic banks. The central bank had also in October 2014 conducted a comprehensive assessment of bank balance sheets, revealing total capital needs of only €24.6 billion across 25 out of the 130 largest banks³¹⁵. The review revealed that the euro area's most important banks were in much better shape than at the start of the crisis, and less likely to fall back on the newly minted ESM tool.

'The results of the recent asset quality review and stress tests confirm that the use of the new instrument seems unlikely,' Regling said on 8 December 2014, when the ESM unveiled the direct recapitalisation tool³¹⁶.

While the tool has remained on the shelf, the financial sector expertise gained along the way has served the ESM well. Not only is the knowledge essential for ongoing programme monitoring, in the future there will be close coordination between the rescue fund and the Single Resolution Board because in 2018 the euro area agreed to make the ESM its backstop for the Single Resolution Fund and to phase out the direct recapitalisation tool once that arrangement is in place.

³¹⁴ ESM (2014), 'ESM direct bank recapitalisation instrument adopted,' Press release, 8 December 2014. <https://www.esm.europa.eu/press-releases/esm-direct-bank-recapitalisation-instrument-adopted>

³¹⁵ ECB (n.d.), 'Results of the 2014 comprehensive assessment'. https://www.bankingsupervision.europa.eu/banking/tasks/comprehensive_assessment/2014/html/index.en.html.

³¹⁶ ESM (2014), 'ESM direct bank recapitalisation instrument adopted,' Press release, 8 December 2014. <https://www.esm.europa.eu/press-releases/esm-direct-bank-recapitalisation-instrument-adopted>

Focus

Carlo and Hugo

The ESM's banking team staged two trial runs of the bank recapitalisation tool, to test it out in practice. The drills were called Project Carlo and Project Hugo, named after the streets around the ESM's headquarters that honour the Luxembourgish economist Carlo Hemmer and the Luxembourgish-American inventor and science fiction publisher Hugo Gernsback.

'It was really a demanding exercise because we were under enormous pressure, as if it were really happening and not just a test,' said Sutt, former ESM head of banking.

Activating the instrument would involve the entire banking team, supported by most of the rest of the ESM. For the first dry run, Project Carlo in March 2014, the ESM also worked with a financial advisory and asset management company, to prepare the exercise and a 600-page handbook on the tool.

The practical tests revealed that the tool had unexpected drawbacks. One of the principle takeaways was that the tool would not be the rapidly deployable emergency instrument that had been intended. Distressed banks would need to have their national government lodge a formal request with euro area finance ministers, the ESM's directors and governors, the relevant directorates-general of the European Commission, and the ECB. In some cases, Members would need to follow their national parliamentary procedures. The ESM also would have to conduct a full analysis of the bank to assess the likelihood of recovering its investment.

Project Carlo, the first test exercise, was based on a real bank in one of the programme countries, but with the data changed for the purposes of a purely hypothetical exercise. Under the simulation, the bank's home country requested the instrument's aid to recapitalise one of its big banks. The ESM team had two and a half days to analyse the bank's financial situation, come up with a workable investment structure, and perform due diligence: stress tests, entry equity valuations, exit routes, and potential exit valuations. To make things even more interesting, the exercise facilitators changed some of the external events halfway through, in keeping with how the crisis had played out in real life.

Instead of granting the requested amount of aid for the troubled bank, the ESM team found it needed to split the bank and provide a large amount of funding, most likely in the form of a regular loan to the country. This led to 'a very small equity investment for direct recapitalisation and a very high

probability that the country was going to have to request a full economic adjustment programme,' said Hesketh of the ESM banking department. Since the direct recapitalisation instrument was designed to help a country in lieu of a standard programme, the realisation that it would work only alongside a full programme was a surprise.

'We all know it would not have been just one bank that needed to be resolved, but probably would result from an overall situation that would have affected the state itself,' said Jansen, former ESM general counsel.

Project Hugo followed in September 2014. It too featured a simulated bank based on real programme country data and a straightforward request for direct aid, but this time with the Commission taking part and other simulated external actors, such as the media. The ECB was invited, but it was too busy conducting its real-life comprehensive banking review to take part.

Bringing in these outside actors highlighted how direct bank investments would dramatically change the ESM's negotiating role, over and above the political difficulties of getting a direct recapitalisation programme in place. The acquisition of a stake in a private company would compel the ESM to protect its investment and negotiate for higher returns on behalf of its shareholders. This might mean navigating trade-offs between what is best for the bank and what regulators might request as part of their efforts to limit taxpayer liability. One example might be whether or not to sell subsidiaries, which might have long-term value to the institution but could also generate upfront cash.

Project Hugo led to the same conclusion as its predecessor: even though the request was for one specific bank, there would be too much contagion for the country to avoid a full macroeconomic programme. The bulk of the programme would probably entail an indirect recapitalisation facility. Direct aid would be a smaller component, at a higher cost.

'The conditions that we would impose for direct recap are very burdensome on the Member,' Hesketh said. 'Essentially, they lose control of a systemically important bank in their country. We make a small equity investment but we're probably taking 70% to 80% of the shares.'

In that scenario, a Member would probably opt not to pursue a direct aid investment. Instead it could aim for a larger indirect facility and maintain control of its banks.

Safeguarding the capital: building a modern, strategic investment architecture

35

The liquidity and credit quality of the capital are there to ensure the ESM's creditworthiness, so that the funds used to lend can be raised, in optimal conditions, at any time.

Carlos Martins

ESM/EFSF Investment and Treasury Portfolio Manager

The ESM's ability to safeguard financial stability is anchored by the paid-in capital provided by its Members. Preserving this capital is therefore essential to fulfilment of the ESM's mission.

Initially the firewall was due to receive its capital gradually over five years. However, to show their determination to make the ESM a credible support mechanism for the common currency, the euro area countries accelerated the contribution schedule that had originally been set out in the ESM Treaty and rapidly created a large pool of cash to invest. The capital thus came in over an 18-month period, with the first two instalments paid simultaneously in autumn 2012, and the final three came on a schedule of one every subsequent six months through spring 2014.

By the end of 2018, the ESM had received €80.5 billion of paid-in capital. When the last additional expected instalments from all ESM Members are received in 2027, the paid-in capital will total €80.8 billion. The ESM has a remit to safeguard these funds, maintain the highest possible

credit rating, and support the euro area in times of market stress. These investment principles have remained unchanged since the firewall began.

When the permanent ESM was created, there was at first no clear roadmap for specifically how to manage the holdings of this new kind of institution. The overarching goal – to preserve liquid holdings and the long-term value of its capital – needed to be translated into investment guidelines that would spell out the universe of potential investments. The fund also had to find the right people to carry out this strategy and create the right systems for them to use.

While the capital's main purpose is to ensure the ESM's highest creditworthiness, it can also be used in emergencies to cover any liquidity needs. Therefore, the ESM's investment guidelines in part resemble those used by central banks to manage their foreign exchange reserves. This means a focus on investing in high-quality securities and keeping a tight rein on market and credit risk. At the same time, the ESM must also maintain its credit rating, in the manner of those international financial institutions that issue debt.

'In deciding how to invest its funds, the ESM is somewhere between a central bank and an international financial institution. The investment rules need to be relatively similar to those of central banks, but the ESM must also make sure it has the highest credit rating to raise funds on financial markets,' said Lévy, the institution's head of investment and treasury. 'In practice, this means that we need to define our own approach and we need to make sure proposed solutions are agreeable to all our 19 shareholders.'

The ESM strives for a portfolio of safe, diversified assets that could be easily converted into cash. Transactions are calibrated so they can be absorbed by the market without having adverse effects on asset prices. As part of its long-term strategy, the ESM aims to avoid large-scale purchases or sales that would disrupt market prices.

In the EFSF's early days, there was no formal investment department. At the start, a team at the Frankfurt-based German Finance Agency handled EFSF debt operations, and this team was initially in charge of investing the short-term liquidity. It also purchased some securities on behalf of the EFSF related to the early Portuguese and Irish programmes, in order to provide investors with additional guarantees. Liquidity management became a bigger part of operations once the EFSF adopted its diversified funding strategy in 2011 and was able to raise money on an independent schedule from its disbursements.

Once the euro area committed to creating the permanent ESM, it was clear that investment activities would grow, in particular when its paid-in capital started to flow in. The firewall began relocating its funding and investment activities in-house.

During the course of 2012, the organisation hired portfolio managers, set up the investment framework, and built the necessary information technology infrastructure. The first head of investment and treasury came from the French central bank, while portfolio managers were recruited from banks, asset managers, public financial institutions, and central banks. The resulting mix of backgrounds reflected the ESM's effort to bridge worlds and to put together a diverse team – but first the team needed to get organised.

'It was very surprising at first. We thought we were recruited to manage assets and instead the first thing we had to do was to come up with an investment framework, test the IT system, and establish policies,' said Carlos Martins, an ESM portfolio manager.

When setting the investment guidelines, the ESM concentrated on debt securities issued by highly rated public entities. At first, the investments were mainly focused on bonds issued in euros by supranational institutions, euro area governments, and public agencies that had a minimum rating equivalent to at least an AA. Over time, as the organisation gained traction, the guidelines have been expanded to allow broader types of investments such as covered bonds and non-euro area issuers, while remaining in line with the original core principles.

The paid-in capital had to be invested in line with these principles and guidelines as it flowed in. For each lump sum, the team developed a ramp-up strategy to place the funds without pushing up asset prices. After all, market participants were generally alert to when the money was due and tried to anticipate the ESM's operations. ESM Managing Director Regling said: 'We had to make sure they couldn't front run us.'

To avoid disrupting markets, the investment team purchased smaller-than-expected amounts and kept its timing flexible, if necessary holding on to the cash until the market was better able to absorb the flows. On average, trade sizes were about €30 million and each instalment was invested over a period of three to four months.

'It was very important to deploy the paid-in capital in such a way that it did not leave a large footprint in the market,' recalled Ivan Semerdjiev, a former Bank of Canada staffer who is now an ESM portfolio manager.

‘Everybody knew it was coming and everybody knew that it would be invested, but generally nobody knew over what period it would be deployed. We didn’t want to make any real ripples and overall we achieved this objective.’

From the start, the investment team closely monitored portfolio allocation and performance, keeping the Management Board apprised of all major events affecting the positions. ‘When I joined, I was pleasantly surprised to discover that the ESM had already implemented a detailed performance-monitoring and attribution system. This type of capacity usually comes later,’ said Lévy.

Senior ESM staff meet monthly to review macroeconomic and financial developments and define the investment strategy for the coming months. This structure was present from the beginning and would be refined as the investment strategy evolved and matured. By checking in regularly, they can analyse recent market developments and adjust the portfolios accordingly. These meetings ensure a robust investment decision-making process.

As the range of instruments expanded, the growing investment team reconsidered its internal organisation. The team manages the ESM’s two main investment pools – one for day-to-day liquidity and one for long-term capital holdings – as well as the EFSF portfolios. Over time, the initial everyone-does-everything approach was reaching its limits. The team considered dividing responsibilities between asset classes and maturities, yet eventually settled on a geographical breakdown.

‘We initially couldn’t find a good approach to distribute assets in a way that would be easy to implement operationally and logical financially. We reviewed many possible options and finally, we thought: “Let’s just split euro area issuers by country and create a specific diversification portfolio for non-euro-area issuers and supranationals,”’ Lévy said. ‘The objective was to create a structure where we would collectively be responsible for the whole investment strategy, but implementation would be divided up in a practical way to enable team members to focus on a particular market segment.’

In establishing itself as a professional investor, the ESM built up a network of counterparties to conduct transactions. As early as 2012, the ESM was working with more than 20 international counterparties, ensuring broad access to the European bond market. This network would eventually expand to include more than 35 counterparties, active across different markets.

Portfolio management posed another set of questions for the institution. The ESM had to determine how to apply professional asset management principles, which required regular market operations, but again without interfering with euro area bond market prices.

‘It was not very clear how active the ESM was supposed to be in the market,’ Martins said. ‘A good illustration of this occurred the first time a portfolio manager sold a bond. The sale raised eyebrows. It was even reported to the internal risk committee; people wanted to understand the rationale behind such an operation.’

To help make its case, the ESM consulted established international financial institutions with extensive fund management expertise. Representatives of the World Bank came to Luxembourg to work with the ESM’s team and provided assurances that the firewall was adhering to best practices. The investment team worked hard to convey the importance of active management to the ESM shareholders.

‘We had to explain what it means to be active in the market as a public institution, and not as a market maker or an active fund manager. We had to reassure the shareholders that it was essential for the ESM to be present in the market and to be ready to act if and when a market intervention was required to provide liquidity,’ said Frankel, ESM deputy managing director and CFO.

Active portfolio management brings a number of benefits. By adjusting the ESM’s asset allocation in response to economic and market conditions, the ESM can contain some of the financial risks and enhance returns, building a cushion on top of the paid-in capital to augment the firewall’s financial strength.

For example, when the ECB implemented its quantitative easing programme in January 2015, there was a dramatic change in market conditions. In response, the ESM reconsidered its asset allocation, switching out of some securities deemed to be over-priced and into others with better return prospects. The ESM also lengthened its maturity investment profile when yields turned strongly negative.

The ESM also needed in-depth market knowledge and capacity to ensure it could tackle the challenges that might come from the implementation of a secondary market purchase programme, where the ESM intervenes in financial markets to purchase securities of an eligible country. To be able to act for the euro area when needed, the ESM put together a team able to trade securities not only in normal conditions but also in periods of market stress and low liquidity.

This instrument has never been used. However, all the preparations were carried out so a programme could be put in place quickly when called upon. As early as 2012, the ESM had built a full set-up with the ECB and the French central bank, the Bank of France. This required special procedures, secure communication networks, and close cooperation between the three institutions. Later, this framework was reviewed to include only the ESM and the Bank of France, as the ECB and the ESM needed to ensure a clear separation of duties.

‘It was essential for the success of the ESM to work closely with these well-established institutions, to have our intervention capacity ready. Initially, it was difficult to coordinate well, but, after two test runs, we knew we were ready to take on our responsibilities,’ said Maria Kartcheva, the ESM’s portfolio manager responsible for this project.

The ESM has been reviewing its investment guidelines regularly, leading to changes in strategy as conditions dictated. In 2013, it became clear that the initial investment framework was working but it was excessively conservative and rigid, even given the ESM’s mandate. Broadening the range of investments was becoming necessary to reinforce the ESM’s long-term financial strength in a time of falling yields, without generating significant risk.

‘By then, it had already become increasingly difficult to meet the diversification requirement included in the investment guidelines, which require 30% of the paid-in capital to be invested in supranational or non-euro area issuers, to reduce the overall concentration on the euro,’ Semerdjiev said. ‘At the time, we could only buy euro-denominated securities. So, we approached a number of supranational entities and asked them to issue some private placements, which we purchased. This flexibility was essential to enable us to comply with the requirement set by our shareholders.’

In one instance in 2015, the ESM undertook a short-term private placement with the EU, an eligible supranational entity, which used it to provide a bridge loan to Greece.

 For more on the bridge loan, see [‘Focus – An unusual money market transaction’](#) in Chapter 37.

Lévy, who joined in November 2014, took on responsibility for the further diversification of the fund’s holdings. Yields were falling at the time and, to avoid losses, the ESM had to expand its investment

universe. Scenario analysis performed in 2015 showed that more needed to be done because of the negative interest rates on most eligible assets. The risk of losses was looming, to the point of possibly threatening the ESM's long-term creditworthiness.

All changes had to be reviewed internally and approved by the 19 members of the Board of Directors. The investment team explained for each proposal how the revision would reinforce the institution without generating undue risk. This proved to be a lengthy process.

The first modifications, in 2015, were incremental, broadening the number of issuers eligible for ESM investments.

'For a very long time, there was no internal agreement. There was a lot of passion about what the ESM could and could not do,' Lévy said. 'Ultimately, we went for a shortcut. We just changed a few lines in the annex, but those changes made quite a big impact.'

These changes increased the amount the ESM could invest in certain eligible issuers like AAA covered bonds or public agencies with a minimum rating of AA. More ambitious revisions of the investment guidelines took another year, and these 2016 changes helped to mitigate the impact of negative interest rates, while minimising overall portfolio risk.

The ESM's investment universe would eventually extend to a wider range of bond issuers, including some with slightly lower ratings than had previously been allowed. In particular, the ESM was allowed in 2016 to invest €75 billion of its capital at a rating equivalent to or above AA- instead of the previous AA rating. The rules also expanded to offer the possibility of investing in covered bonds, sub-sovereign government issuers, and a broader geographical range of issuers, and it enabled the ESM to fully deploy derivative instruments to manage foreign exchange and interest rate risk.

To invest most effectively, the ESM needed to build its investment capacity, so it launched a number of initiatives in parallel. Initially, the only result was a logjam; none of the projects were getting finished. For Lévy, the question was how to prioritise the initiatives the investment team was working on.

'People were trying to achieve a massive project, called "new instruments", and were starting to get frustrated at the lack of progress,' Lévy recalled. 'We decided to change the approach and target some

quick wins. We managed to convince the different teams that it would be more efficient to cut the project into more digestible chunks and focus on short-term non-euro investments traded with public institutions, without collateral. That worked.'

Within six months, the first of the new instruments – foreign exchange swaps and forwards – were coming on board, enabling the ESM to conduct the first non-euro investments. By the end of 2015, the ESM had invested about €2.0 billion in Danish kroner and Japanese yen, hedged into euros to avoid the currency risk, helping to diversify holdings and improve returns. The ESM also laid the groundwork for investing in assets denominated in nine major countries' currencies: Australia, Canada, Denmark, Japan, Norway, Sweden, Switzerland, the UK, and the US.

By 2016, the ESM could enter into repurchase agreements (repos) to broaden its investment capacity and to raise liquidity in emergencies. This capability was phased in over time. At first, permission was limited to reverse repos, the equivalent of a collateralised deposit. Later on, the ESM added traditional repo operations, lending out securities from the portfolio to receive cash.

'If we need to introduce a new type of instrument to fulfil our mandate, we will act on it; we have a 'can-do' approach,' ESM Chief Risk Officer Pacciani said. 'We also have a strong risk culture and a prudent approach. So, we always look at best market practices to build our own standards, our own limits, and methodologies. We aim to be modern and prudent at the same time and we reflect these two dimensions in our risk management framework.'

In 2015 and 2016, one of the principal strategies to enhance the portfolio's performance was to move into cash. At the time, the ESM's paid-in capital was fully invested in securities, but plunging interest rates necessitated a re-allocation. Drawing on its eligibility to leave funds at the Bundesbank at 0% interest, even when deposit rates went well below that, the ESM swung heavily into cash – €45 billion at the end of 2015 and €60 billion at the end of 2016. This reduced the ESM's interest rate sensitivity in a depressed market environment.

'When yields started to fall into negative territory, we had an incentive to sell our bonds and leave the cash at 0% instead of keeping assets with negative interest rates. We never thought we would end up selling about three quarters of our portfolio's assets. We looked for alternative investments, but very few eligible assets could offer a positive return,' Lévy said.

However, these exceptional conditions did not last for the ESM and EFSF. In late 2016, the ECB informed the ESM that it would be treated like many other public institutions and that the cash left in euro area national central banks would be charged the ECB's deposit facility rate, set at -0.40% at the time. The ESM and EFSF started paying these charges in early 2017.

With these conditions still relatively more favourable than short-term securities, which offered investment returns close to -0.50%, the ESM kept a large part of its assets in cash. It had to count on its accumulated reserves to absorb the expected losses.

Germany and France stepped in to ease the burden. Concerned that these charges might affect the financial strength of the rescue fund, the finance ministers from these countries pledged to reimburse, for a temporary period, the negative interest paid to their national central banks. In 2018, France and Germany made good on that commitment, reimbursing interest paid by the ESM to their national central banks the previous year.

‘Capital preservation in a negative yield environment is arguably the restriction that is the most challenging to comply with,’ Semerdjiev said. ‘We have proposed other solutions to address this issue but, in the end, it will be the responsibility of our shareholders to decide where they would like the balance to be between risk and return.’

In 2017, after three years of preparation, the ESM began to conduct cross-currency swaps, facilitating investments in foreign currency assets without the accompanying currency risk. To do so, the ESM updated the risk framework and the information technology system. This was a difficult task, because the crisis had left regulations in flux and public institutions without a standardised approach. The ESM had to define its own approach. In doing so, the ESM became one of the first public international financial institutions to implement a bilateral collateralisation for its derivative operations, providing the ESM with broad access to market liquidity and competitive pricing. Other public institutions are currently considering this framework.

Overall, the investment strategy has succeeded. However, constant vigilance is essential. In 2017, with the pressure of negative interest rates, the capital recorded a loss of €124 million³¹⁷. The agreement to

³¹⁷ ESM (2018), *ESM annual report 2017*, p. 46, 21 June 2018, Publications Office, Luxembourg.
<https://www.esm.europa.eu/sites/default/files/ar2017final.pdf>

reimburse the ESM for the negative interest paid to some euro area national central banks is temporary, by nature. In these conditions, the ESM and its shareholders will have to review its investment framework regularly to make sure it remains fit for purpose.

‘The portfolio needs to stand up to stress testing,’ Pacciani said. ‘For example, what if interest rates go back to past historical levels? What if they stay in negative territory for longer than expected? We need to test the resilience of the institution and build capacity to withstand further challenging times.’

From 2012 to 2017, the ESM’s capital recorded an accumulated return of more than €1.2 billion, which has been kept in reserves, to cover the ESM’s future needs and help it achieve its goal of long-term capital preservation. This gain is more than €750 million above the performance of the ESM’s benchmark portfolios over the same period.

‘This shows that, in the end, all the efforts of the ESM to build its investment capacity and enhance return in a prudent manner brought some tangible results, for the whole institution,’ Lévy said.

Focus

Hedging against risk

As its operations have grown, the ESM has turned to derivatives to help it manage financial risks. In 2017, for example, the ESM took further steps to expand its investor base, manage the interest rate risk on Greece’s ESM loans, and preserve its capital. Specifically, it conducted the short-term debt relief measures for Greece at the behest of euro area finance ministers, issued its first non-euro bond, and broadened its investment universe geographically.

All these actions could have exposed the rescue fund to detrimental shifts in interest rates or foreign exchange rates. But derivatives, which are financial instruments whose price fluctuates based on an underlying asset, can help protect against such risks. The ESM put in years of preparatory work by its legal, risk, technology, funding, investment, and asset liability management teams to set up a framework for derivatives, and then it expanded their use in 2017.

The ESM uses derivatives such as interest rate swaps, foreign exchange swaps and forwards, and cross-currency swaps. In particular, the ESM deploys interest rate swaps to reduce the risk that Greece would have to pay a higher interest rate on its loans should market rates rise. In addition, for the US dollar bond issuance, the ESM hedged its US dollar cash flows from bond issues back into euros – the currency in which its programme country loans are denominated.

‘Derivatives are an important tool for us to mitigate certain risks related to our activities,’ said ESM Funding Officer Klaus, a former derivatives trader. ‘We are not a bank. We are not here to speculate. The derivatives are not there to be structured in complex financial products. What we’re talking about are plain vanilla derivatives to mitigate risks.’

The ESM applies a prudent framework for its credit exposures to derivative counterparties, which include public sector entities and commercial banks with high credit ratings. For operations with commercial banks, all derivative-related exposures are fully collateralised in cash or highly rated securities, on a daily basis. For lower-rated bank counterparties, the ESM can contractually request additional collateral to reduce credit risks.

Olivier Pujal, currently senior advisor to the ESM secretary general and former deputy head of the asset liability and management (ALM) team, said that, by using derivatives, the ESM reduced interest rate risk for Greece on its ESM loans. ‘Through derivative instruments, we try to limit variability of the ESM cost of funding by locking that cost in as much as possible at current long-term rate levels,’ he said.

Questions that needed to be addressed included contract structure, collateral, and custodian arrangements. For the time being, the ESM has ruled out the use of central clearing facilities for derivatives transactions, as those facilities handle only certain kinds of trades.

The ESM keeps its investing and funding books separate, by barring some data sharing between the departments. The solution was to pull together all derivatives transactions under one International Swaps and Derivatives Association Master Agreement, while the investment and funding teams each have their own credit support annexes with the commercial banks that serve as counterparties. Having two credit support annexes separates the day-to-day collateral needs of each book, while the single Master Agreement guarantees that all positions are netted if a counterparty defaults, keeping the ESM’s overall credit risk exposure at a minimum. Negotiations started in late 2016, and in February 2017 the ESM signed up its first group of banks.

Within the rescue fund, in the context of the Greek measures, the ALM team developed the calculation tools to monitor the volumes, maturities, and pricing of the derivative transactions, while the funding team was responsible for the optimal execution on the market.

'Thanks to these tools developed in-house, the traders know at all times what operations can be done, and they can search for the best price within those parameters, while ALM checks that everything is done properly,' Pujal said.

Programme countries aren't the only potential beneficiaries of these instruments. Foreign exchange and interest rate derivatives have also widened the ESM's borrowing flexibility and provided more avenues for the investment of the paid-in capital.

Derivatives made it possible for the rescue fund to sell its first dollar bond on 24 October 2017. The 5-year bond raised \$3 billion³¹⁸, and the ESM executed cross-currency swaps to lock in a set foreign exchange rate over the life of the transaction. Using derivatives, the ESM can swap all funds back into euros as soon as they are raised, as well as convert euros into US dollars at a pre-set rate so that the ESM can make the coupon and principal payments on the US dollar bonds.

Likewise, foreign exchange derivatives are employed for the purchase of securities outside the euro area. Swaps made their debut in 2015 when the ESM began investing in Japanese yen and Danish krone bonds. For portfolio diversification purposes, the rescue fund can now conduct operations in nine currencies. By 2018, the ESM had invested more than €7 billion across eight non-euro currencies.

'Everything has to be swapped back into euros to avoid currency risk,' said ESM Portfolio Manager Semerdjiev. In the beginning, the firewall could buy non-euro-denominated securities only with maturities of two years and shorter. In the interim, the ESM worked up a more comprehensive derivatives strategy and is now capable of all necessary cross-currency trades.

On the investment side, derivatives are included in a set of risk metrics employed to monitor the market risk of the ESM's portfolios. In particular, they are fully integrated in the standard value-at-risk measures to ensure that the ESM's overall investment risk remains within the limits defined by the ESM's shareholders.

³¹⁸ ESM (2017), 'ESM debuts in dollar market, raises \$3 billion,' Press release, 24 October 2017. <https://www.esm.europa.eu/press-releases/esm-debuts-dollar-market-raises-3-billion>

Moving towards Grexit: at the cliff's edge

36

In June 2015, Greece was very close to the edge. Grexit was very, very close, and I'm extremely happy that it was possible to prevent that.

Klaus Regling

ESM Managing Director and EFSF Chief Executive Officer

Greek voters, bitter over the wage and pension cuts required by the troika, sought change via Syriza, the party led by the charismatic newcomer Alexis Tsipras. He became prime minister on 26 January 2015, with one month left in the second rescue programme and no prospect of an agreement on the final review in sight³¹⁹.

Instead of plunging into negotiations with the creditors, however, Tsipras weighed his options. The Eurogroup realised that the newly installed government would need time to figure out a strategy. But Syriza was initially adamant that it wouldn't ask for an extension to the existing rescue, since the whole premise of its campaign was to expel the troika.

³¹⁹ *Guardian* (2015), 'Alexis Tsipras sworn in as new Greek prime minister – as it happened', 26 January 2015. <https://www.theguardian.com/world/live/2015/jan/26/greece-election-syriza-victory-alexis-tsipras-coalition-talks-live-updates>

2015

25 January

Syriza party wins parliamentary election in Greece, and Alexis Tsipras becomes prime minister the next day.

4 February

ECB suspends eligibility of minimum credit rating requirements for Greek bonds used as collateral in Eurosystem monetary operations.

20 February

Eurogroup agrees to Greek request to extend second programme. A week later, the EFSF Board of Directors approves four months of extra time.

8 April

Prime Minister Tsipras goes to Moscow for talks with Russian President Vladimir Putin.

24 April

Eurogroup's Dijsselbloem says that there are 'still wide differences' between the creditors and Greece.

12 May

To meet a €750 million debt repayment instalment to the IMF, Greece taps its IMF holding account.

4 June

Greece informs IMF that it will delay a scheduled €300 million loan repayment.

22 June

Emergency EU summit tentatively welcomes reform proposals but fails to reach agreement.

26 June

Greece abandons talks with creditors.

27 June

Eurogroup refuses to extend EFSF programme for Greece.

29 June

Bank holidays and capital controls are introduced.

30 June

EFSF financial assistance programme expires. Greece fails to make IMF loan repayment.

1 July

Eurogroup reconfirms its refusal to extend EFSF programme for Greece.

5 July

In a referendum, voters reject creditors' rescue conditions.

6 July

Yanis Varoufakis resigns as finance minister and is replaced by Euclid Tsakalotos.

8 July

Greece applies to the ESM for a new financial assistance programme.

The new government was making a good-faith effort to reflect Greek voters' frustration at the effects of the economic adjustment programmes, said Euclid Tsakalotos, one of Tsipras's chief negotiators, who became finance minister in mid-2015. 'I think that the Greek government in the first six months tried to change the agenda – they genuinely believed that we couldn't just ignore a popular vote that said we needed change in direction and they tried to explain that to the Europeans,' Tsakalotos said. 'It was worth an attempt to change. It did raise many issues. Many of the issues we raised in the first six months are now being discussed quite seriously.'

The political shift spelled the end of the fragile cooperation with the international institutions that had helped the second programme make as much progress as it did. From the perspective of the euro area authorities, Greece in the first half of 2015 turned its back on its prior agreements and lost its way out of the economic quagmire.

'The Greek authorities decided to no longer comply with the agreement with international institutions after they won the elections in early 2015. Therefore, the Greek support programme went completely off track,' said Dijsselbloem, former Dutch finance minister, who was Eurogroup president and chairman of the ESM Board of Governors through the latter part of the crisis.

On 4 February, just over a week after Tsipras took office, the ECB cancelled its waiver of minimum credit-rating requirements for Greek bonds that had been used as collateral for the Eurosystem's monetary operations³²⁰. In plain terms, given that Greece's sovereign credit rating was below investment grade, Greek bonds would no longer be eligible for any of the central bank's bond-buying programmes, nor could banks use them as collateral for ECB loans. The central bank said the decision – which took effect on 11 February – was a direct result of Greece's inability to conclude its rescue programme review.

This put Greek banks in a difficult spot. Without eligible collateral, they could no longer use the ECB's normal system of bank lending. Instead, they would have to go to the Bank of Greece to request Eurosystem emergency liquidity assistance. In the past, emergency

³²⁰ ECB (2015), 'Eligibility of Greek bonds used as collateral in Eurosystem monetary policy operations', Press release, 4 February 2015.

<https://www.ecb.europa.eu/press/pr/date/2015/html/pr150204.en.html>

liquidity had been a largely technical central banking operation with little or no public discussion, but now the Eurosystem's decisions carried enormous weight and the markets reacted to the slightest fluctuations in the use of the funds. The vicious bank-sovereign circle was tightening around the Greek economy once again.

'The developments we witnessed in the first half of 2015 were the results of deliberate political decisions, but the risk of crisis they created was also a stark reminder that there should be no complacency about the functioning of our monetary union,' said Juncker, who was by this point the European Commission president. 'Personally, I never believed that Greece could leave the euro, and I said so publicly.'

Personality conflicts compounded the negotiating dilemmas. As his government's first finance minister, Tsipras picked Yanis Varoufakis, a UK-educated economist who had taught in the US and Australia. Varoufakis arrived at his inaugural Eurogroup meeting in February 2015 with a host of ideas for righting the Greek economy. Addressing fellow finance ministers for the first time, Varoufakis spoke out against budget cutting, backed an increase in the Greek minimum wage, was wary of privatisation – and asked for a bridge loan to tide Greece over the next few months.

The Syriza government's relations with creditors were often fraught. When it took office, the euro area had already given Greece a two-month technical extension on the programme, and adding more time proved contentious. It was only after 10 further days of discussions that the Eurogroup granted a four-month extension of the second programme, rejecting Greece's bid for six months³²¹.

For a brief period, Varoufakis drew as much attention as Greece's debt, bond yields, pension cuts, or asset sales. Critics accused him of squandering an opportunity to win concessions for the newly installed government. 'He managed to have 18 enemies. That's all he did,' Hardouvelis, his predecessor as finance minister, was quoted as saying in the 3 August 2015 issue of the *New Yorker*³²².

³²¹ 'Remarks by Jeroen Dijsselbloem at the press conference following the Eurogroup meeting of 20 February 2015', 20 February 2015.

<http://www.consilium.europa.eu/en/press/press-releases/2015/02/20/eurogroup-press-remarks/>

³²² *New Yorker* (2015), 'The Greek warrior', 3 August 2015.

<https://www.newyorker.com/magazine/2015/08/03/the-greek-warrior>

In response, Tsipras elevated negotiations over Greece's fate to the highest level. It was unusual for heads of government to delve into the minutiae of the rescue negotiations, a task that had been the domain of the finance ministers and their subordinates. Tsipras's brand of leader-to-leader diplomacy won Greece few allies, given the huge gap between what Athens was seeking and what the euro area was prepared to grant.

Euro area leaders yielded on a symbolic point, dropping the term 'troika' and, with an interim stop at 'quadriga', redesignating the international authorities as 'the institutions'. This was an effort to defuse the Greek public's resistance to troika oversight. 'The Greeks were obsessing over it. I thought, what's in a name?' said Wieser, former chairman of the Eurogroup Working Group.

The name change also reflected the rescue management team's expansion from the three original members to include the ESM. Once the third programme came into focus, the firewall took on a larger role in debt sustainability analysis and programme monitoring. By that point it also had built up substantial expertise on Greece – where the rescue fund had become the largest creditor – and in managing aid programmes generally.

The ESM's mandate allowed it to focus on Greece's finances and its risk of default, including how to define what that would look like and what sort of legal and financial consequences might result. The other institutions had taken a more general approach to monitoring macroeconomic data and Greece's public finances. Giammarioli, who became the ESM's Greece mission chief in January 2015, said the ESM's viewpoint gave it additional credibility with euro area member states, since the firewall was keeping a close eye on how developments in Greece could in turn affect their finances. Increased monitoring began in the first half of 2015, as the second programme broke down, before evolving into a more formal role later in the year as the follow-on package took shape.

'Around March to July we escalated the process, specifically for Greece,' Giammarioli said. 'We created an emergency situation room in case there was a default, with procedures on what legal acts would need to be signed, and so on. It was quite challenging. This was all to reassure the Members that we were prepared for any possible negative event.'

Also in early March, Greece submitted a new round of proposals to the Eurogroup, to a tepid response at best. As correspondence flew back and forth between Athens and the other capitals, financial markets were becoming more pessimistic. At the end of March, Fitch downgraded Greece to CCC from B, and a few weeks later Standard & Poor's cut Greece to CCC+ from B, with Moody's following suit soon afterwards³²³. During this period, Tsipras went to Moscow on 8 April 2015 for talks with Russian President Vladimir Putin³²⁴. The meeting didn't yield much in the way of concrete developments, but it sent a signal that Tsipras was far from finished seeking alternatives to the euro area reform plan.

Stournaras, who was appointed Bank of Greece governor in June 2014, said Varoufakis reacted to the growing tensions within the Eurogroup by invoking 'Plan B' scenarios rather than shifting into a more pragmatic gear. Talk of seeking money from Russia, parallel currencies, or even taking over the Greek central bank overshadowed negotiations with the euro area, eating into public confidence and further upsetting markets.

'He thought that he could become a hero. He played save or destroy,' Stournaras said. 'But a finance minister must be careful and risk-averse. He should not roll the dice as a way to determine the future of his country.'

Varoufakis thought Greece would hold a stronger negotiating hand if he could show how Grexit might be feasible. He later detailed this rationale in a book he wrote after the crisis³²⁵.

As April drew to a close, Dijsselbloem said there was still a wide gulf between Athens and its international creditors. Dijsselbloem felt that Syriza's election campaign had set the stage for the unproductive talks. 'Undoubtedly the Greek government presented unrealistic promises in its election campaign, which created problems when they were in office,' Dijsselbloem said.

Tsipras reshuffled his negotiating team in April, keeping Varoufakis as finance minister but replacing him with Deputy Foreign

³²³ TradingEconomics (n.d.), 'Greece – credit rating', <https://tradingeconomics.com/greece/rating>.

³²⁴ *New York Times* (2015), 'Putin meets with Alexis Tsipras of Greece, raising eyebrows in Europe', 8 April 2015. <https://www.nytimes.com/2015/04/09/world/europe/putin-russia-alexis-tsipras-greece-financial-crisis.html>

³²⁵ Varoufakis, Y. (2017), *Adults in the room*, Penguin, London.

Minister Tsakalotos as the chief go-between in day-to-day talks with the European institutions³²⁶. The move also brought in George Chouliarakis to serve on the Eurogroup Working Group of finance ministry deputies, replacing a Varoufakis ally. While the new team shared Tsipras's politics, they practised a more low-key style that smoothed discussions at the technical level. For his part, Varoufakis continued to take an active role politically.

Progress remained elusive. With more than half the extension period gone, Greece was forced in May to tap into its IMF reserves holding account to meet a €750 million repayment instalment to the Washington-based lender, an unusual use of the funds that underscored the precariousness of Greek finances³²⁷. Greece's relations with the IMF suffered.

On 4 June, Greece told the IMF it would delay its next scheduled loan repayment of €300 million³²⁸. Meanwhile, talks with the euro area bogged down. Greece rejected creditors' reform proposals and countered with another plan of its own. The IMF responded that there were 'major differences'³²⁹ between the two sides. With an agreement nowhere in sight, technical talks in Brussels broke down. In mid-June, the Eurogroup urged Greece to make new proposals, saying 'time is really running out'³³⁰.

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- ³²⁶ *Guardian* (2015), 'Greek finance minister Yanis Varoufakis replaced as leader of debt talks', 27 April 2015. <https://www.theguardian.com/world/2015/apr/27/greece-reshuffles-negotiating-team-creditors-yanis-varoufakis>;
Reuters (2015), 'Greece moves to sideline Varoufakis after reform talks fiasco', 27 April 2015. <https://www.reuters.com/article/us-eurozone-greece-varoufakis/greece-moves-to-sideline-varoufakis-after-reform-talks-fiasco-idUSKBN0NI0VI20150427?feedType=RSS&feedName=worldNews>
- ³²⁷ Reuters (2015), 'Greek PM says time for action from lenders, IMF payment scrapes by', 12 May 2015. <https://uk.reuters.com/article/uk-eurozone-greece/greek-pm-says-time-for-action-from-lenders-imf-payment-scrapes-by-idUKKBN0NX0QW20150512>
- ³²⁸ *Guardian* (2015), 'Greece moves closer to Eurozone exit after delaying €300m repayment to IMF', 4 June 2015. <https://www.theguardian.com/business/2015/jun/04/greece-delays-300m-payment-to-imf>
- ³²⁹ IMF (2015), 'Transcript of a press briefing by Gerry Rice, director, communications department, International Monetary Fund', 11 June 2015. <https://www.imf.org/en/News/Articles/2015/09/28/04/54/tr061115>
- ³³⁰ Press remarks by Eurogroup president following the Eurogroup meeting on 18 June 2015, 18 June 2015. <http://www.consilium.europa.eu/en/press/press-releases/2015/06/18/press-remarks-eurogroup-president/>

In a bid to break the impasse, European Council President Donald Tusk – who had succeeded Van Rompuy in December 2014 – launched a frenetic diplomatic initiative by calling euro area leaders to Brussels for an emergency summit on 22 June 2015. Greece pulled together another set of proposals in time for the summit, reaping a cautious welcome from the leaders. It was then up to Tsipras, the institutions, and Eurogroup finance ministers to nail down an accord before the second Greek programme ran out on 30 June.

It wasn't to be. In a week of discussions among technical experts and finance ministers, punctuated by a regularly scheduled EU summit³³¹, Greece mooted economic reforms and budget savings that didn't go far enough for the creditors. Ideas were floated, but no plan for a new, comprehensive pact was formally presented. Late on Friday 26 June, the Greek negotiators walked away from the table. Early in the morning of 27 June, Tsipras announced he would hold a referendum to let the Greek people decide whether or not to accept the creditors' latest rescue conditions³³².

That day, euro area finance ministers met, converting what had been scheduled as a final drafting session for the new programme into a discussion of an altogether different sort. There were four days left in Greece's second rescue, even after the extension. Once it expired, Greece would lose not only its undisbursed funds, but also access to some of the other cash-boosting measures the euro area had granted, such as the sharing of central bank profits on Greek bonds held by the Eurosystem. Instead of a smooth path to a follow-on aid programme, it looked as if Greece might end up with nothing.

Greece dissented from that Saturday's Eurogroup statement, reflecting the rupture between Athens and the rest of the currency union. 'We stress that the expiry of the EFSF financial arrangement with Greece, without immediate prospects of a follow-up arrangement, will require measures by the Greek authorities, with the technical assistance of the institutions, to safeguard the stability

³³¹ *Guardian* (2015), 'Greece bailout talks break down again', 25 June 2015.

<https://www.theguardian.com/business/2015/jun/25/greece-bailout-crisis-last-minute-search-deal>

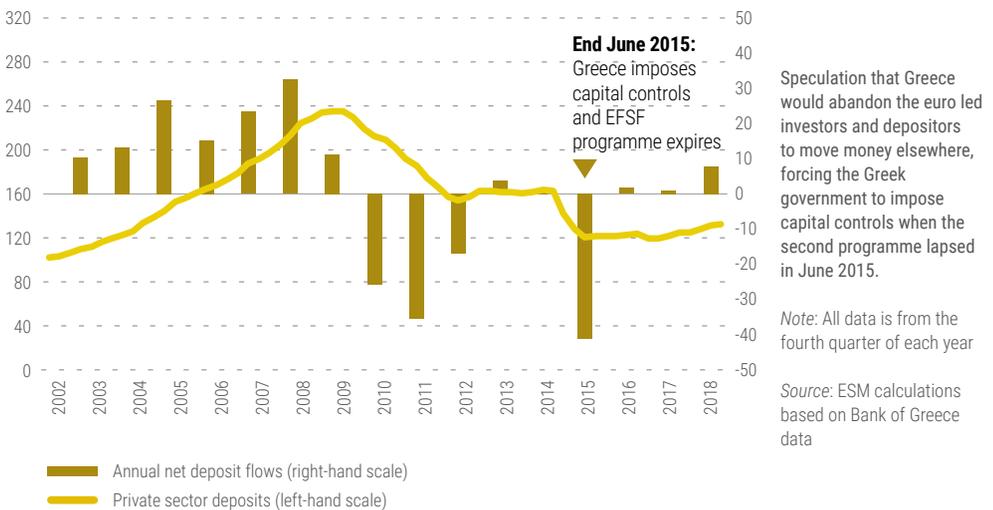
³³² Eurogroup statement on Greece, Press release, 27 June 2015.

<http://www.consilium.europa.eu/en/press/press-releases/2015/06/27/eurogroup-statement-greece/>

of the Greek financial system³³³, the statement by the other 18 finance ministers said. They pledged to monitor conditions, stand ready to help Greece, and reconvene as needed.

On Sunday, 28 June, Greece announced it would impose capital controls and a bank holiday when markets opened on Monday³³⁴. The next day, on Tuesday, the second rescue programme lapsed, taking with it the prospect of any further EFSF lending³³⁵. Greece missed an IMF payment³³⁶, the Eurogroup stood its ground, and Greek citizens faced an arduous week of no access to their banks and no prospect of international help.

Private sector deposits and annual net deposit flows – Greece in € billions



³³³ Euro area member states except Greece (2015), Ministerial statement on 27 June 2015, Press release, 27 June 2015.

³³⁴ *Guardian* (2015), 'Greek crisis: Banks shut for a week as capital controls imposed – as it happened', 25 June 2015. <https://www.theguardian.com/business/live/2015/jun/28/greek-crisis-ecb-emergency-liquidity-referendum-bailout-live>

³³⁵ ESM (2015), 'EFSF programme for Greece expires today', Press release, 30 June 2015. <https://www.esm.europa.eu/press-releases/efsf-programme-greece-expires-today>

³³⁶ IMF (2015), 'Statement by the IMF on Greece', Press release, 30 June 2015. <https://www.imf.org/en/News/Articles/2015/09/14/01/49/pr15310>

‘Capital controls were a crisis measure,’ ESM Managing Director Regling said. ‘They should not happen in a monetary union, although it was the second time – they also happened in Cyprus in 2013. And still it was a shock. It would have been better not to get into a situation where that becomes unavoidable. But given where Greece was, there was no choice.’

The referendum went ahead on 5 July³³⁷. Public anger was unequivocal: Greeks voted by a margin of 61% to 39%³³⁸ to denounce the international creditors and protest against the hardships that had befallen them since the extent of the government’s budgetary woes surfaced in 2009.

Immediately after the referendum, however, Tsipras relaunched his outreach to the creditors. He began by asking Varoufakis to resign as finance minister³³⁹, replacing him with the more diplomatic Tsakalotos³⁴⁰. ‘In the six months of the Varoufakis tenure, about €45 billion deposits left. That says everything,’ Stournaras said. ‘This led to capital controls with the declaration of the referendum.’

On 8 July, Tsipras sought a new ESM programme. Having given voice to public grievances over the distressed state of the economy and the privations resulting from five years of spending cuts, the Greek prime minister seized the opportunity for a fresh start. A day after requesting aid, Greece submitted a new set of reform plans that would anchor a third rescue programme. It was time to turn the page.

 Greek programme history, which began in Chapters 3, 19, and 22, continues in Chapters 37 and 38.

³³⁷ *Wall Street Journal* (2015), ‘Greek referendum hangs on voters’ understanding of question’, 30 June 2015. <https://www.wsj.com/articles/greek-voters-to-decide-on-convoluted-bailout-question-july-5-1435691134>

³³⁸ *Guardian* (2015), ‘Greek referendum: No campaign storms to victory with 61.31% of the vote – as it happened’, 6 July 2015. <https://www.theguardian.com/business/live/2015/jul/05/greeces-eurozone-future-in-the-balance-as-referendum-gets-under-way--eu-euro-bailout-live>

³³⁹ Reuters (2015), ‘Greek finance minister Varoufakis resigns – statement’, 6 July 2015. <https://www.reuters.com/article/eurozone-greece-varoufakis/greek-finance-minister-varoufakis-resigns-statement-idUSA8N0ZC02A20150706>;

Independent (2015), ‘Yanis Varoufakis resigns: His statement in full’, 6 July 2015.

<https://www.independent.co.uk/news/world/europe/yanis-varoufakis-resigns-live-greek-crisis-his-statement-in-full-10368320.html>

³⁴⁰ *New York Times* (2015), ‘Rift emerges as Europe gears up for new talks on Greece bailout’, 6 July 2015. <https://www.nytimes.com/2015/07/07/business/international/yanis-varoufakis-abruptly-resigns-as-greek-finance-minister.html>

Turning the corner: Greece's third programme

37

*Grexit would have been a disaster for Greece,
a disaster.*

Yannis Stournaras

Governor of the Bank of Greece (since June 2014)
and Greek Finance Minister (July 2012–June 2014)

Greek banks were shut and in need of cash when the government at last requested a third programme. On 10 July 2015, a Friday, the European Commission and the ECB responded favourably to the Greek request for an ESM loan, warning that ‘an uncontrolled collapse of the Greek banking system and of Greece as a sovereign borrower would create significant doubts on the integrity of the euro area as a whole’³⁴¹.

But the flipside was that some of Greece’s fellow euro countries were at their limit. On that same day, a proposal was circulating out of Germany that suggested Greece should leave the euro if it wouldn’t agree to more stringent reforms. Commission President Juncker had said earlier in the week that the EU had a Grexit plan ‘prepared

³⁴¹ European Commission (2015), ‘Greece – request for stability support in the form of an ESM loan: Assessment’, Online report, 10 July 2015. https://ec.europa.eu/info/sites/info/files/2015-07-10_greece_art_13_eligibility_assessment_esm_en1_0.pdf

2015

12 July

At euro area summit, leaders agree to move towards a third rescue programme, provided Greece meets a series of tough conditions – a deal that effectively prevents Grexit.

17 July

EU approves €7 billion European Financial Stabilisation Mechanism bridge loan to Greece, facilitated by ESM private placement.

20 July

Banks reopen after a three-week shutdown.

14 August

Eurogroup agrees the third financial assistance programme of up to €86 billion.

18 August

Fitch upgrades Greek debt to CCC from CC, the first in a series of upgrades.

20 August

First ESM disbursement (€13 billion).

20 September

Election confirms Syriza as the largest party; Alexis Tsipras remains prime minister.

1 December

ESM Board of Directors approves €2.7 billion disbursement to recapitalise Piraeus Bank, and a similar sum to National Bank of Greece a week later.

2016

9 May

Eurogroup welcomes Greek reforms, and agrees debt relief measures for Greece in the short, medium, and long term.

2017

23 January

ESM and EFSF approve short-term debt relief measures for Greece, which they implement throughout the year.

25 July

Greece returns to international capital markets for the first time since 2014 with a 5-year bond sale, raising €3 billion.

2018

22 June

Eurogroup agrees to move ahead on medium-term debt relief measures for Greece, including maturity extensions and further deferral of EFSF interest.

20 August

Greece successfully exits the ESM programme.

in detail³⁴², but he had continued to advocate Greece's place in the monetary union. The Friday proposal, shown to a select group of high-ranking officials, made it clear that leaving the euro, at least temporarily, was now on the table³⁴³.

Over the course of the weekend, negotiations would lead to an overnight debate to decide Greece's fate – and if euro membership was as irrevocable as promised. In the end, Greece and the common currency would remain joined, but the path would not be easy.

On Sunday 12 July, European leaders gathered for another summit that would prove to be the deciding moment for Greece's membership in the euro. The talks stretched on for hours. Tsipras met at least four times with the EU's Tusk, France's Hollande and Germany's Merkel. Around 6.00, Merkel, Hollande, and Tsipras were ready to throw in the towel, but Tusk refused to let them step out of the room. 'Sorry, but there is no way you are leaving this room,' the former Polish prime minister said, according to a report in the *Financial Times*³⁴⁴.

The talks resumed. After intense negotiations, the member states decided on Monday morning to move towards a third rescue programme, provided that Greece met a host of tough conditions. To allow time for these criteria to be met, the EU also prepared for a bridge loan that would tide Greece over until it could get its full programme up and running. The combination of the bridge loan and the next rescue would prevent Grexit, once the measures could be put in place.

Euro area leaders set out a list of 'minimum requirements' for proceeding with the talks.³⁴⁵ Just to start the process, Greece was granted 10 days – until 22 July³⁴⁶ – to pass legislation to broaden the tax base, streamline value added tax procedures, reform the pension system, ensure the independence of the statistical agency, implement EU budget oversight rules, update its Code of Civil Procedure, and

³⁴² European Commission (2015), 'Result of the euro summit on Greece', 8 July 2015.

http://europa.eu/rapid/press-release_AC-16-1834_en.htm;

Euractiv (2015), 'Juncker: We have a Grexit scenario prepared in detail', Video, 8 July 2015.

<https://www.euractiv.com/section/economy-jobs/video/juncker-we-have-a-grexit-scenario-prepared-in-detail/>

³⁴³ *Guardian* (2015), 'Three days that saved the euro', 22 October 2015.

<https://www.theguardian.com/world/2015/oct/22/three-days-to-save-the-euro-greece>

³⁴⁴ *Financial Times* (2015), 'Greece talks: "Sorry, but there is no way you are leaving this room"', 13 July 2015. <https://www.ft.com/content/f908e534-2942-11e5-8db8-c033edba8a6e>

³⁴⁵ Euro summit statement, SN 4070/15, 12 July 2015.

<http://www.consilium.europa.eu/media/20353/20150712-eurosummit-statement-greece.pdf>

³⁴⁶ *Ibid.*

enshrine the EU's directive for handling bank failures in national law³⁴⁷. Greece would also need to commit to seeking further IMF aid in 2016, when its existing programme was due to expire.

The impositions were necessary because of 'the need to rebuild trust with Greece,' as the 12 July summit statement³⁴⁸ put it. Further aid was contingent on Greece grasping that the reforms were in its own interest, as then-German Finance Minister Schäuble explained. 'If there is no ownership on the part of the government, it cannot work,' he said, noting that, with Greece, there was 'always the risk that decisions may not be implemented with sufficient determination or that they get watered down. A certain degree of basic support among the population is necessary as well.'

In the subsequent negotiations with the institutions, Greece was required to pursue ambitious further pension reforms, strengthen its banking sector, privatise its electricity transmission network, deregulate 'closed' professions such as ferry transport, modernise its labour bargaining system, and set up a fund to generate €50 billion from state-owned assets³⁴⁹.

During those critical July days, Greece faced a serious cash crunch. Being late sending money to the IMF would prompt a scolding, while defaulting on an upcoming payment to the ECB would automatically shut off Greece's access to funds. But, with ESM funds not yet available, how could Greece find the money it needed in the interim?

The solution came from the Commission's European Financial Stabilisation Mechanism (EFSM), which had been used early in the crisis to help Ireland and Portugal. It had since been idle, but remained a suitable vehicle to provide a bridge loan to tide Greece over.

³⁴⁷ *Guardian* (2015), 'Greek parliament approves next phase in bailout reforms', 23 July 2015. <https://www.theguardian.com/world/2015/jul/22/greece-ecb-emergency-assistance-ceiling-raised-bailout-vote>

³⁴⁸ Euro summit statement (2015), SN 4070/15, 12 July 2015.

<http://www.consilium.europa.eu/media/20353/20150712-eurosummit-statement-greece.pdf>

³⁴⁹ *Ibid.*

Unlike the ESM, run by euro nations with a stake in the currency's stability, the EFSM is managed by the entire EU and underwritten by the EU budget. This meant securing the agreement of nine additional EU Member States, which were not part of the euro area. The UK held out³⁵⁰; after voluntarily participating in some of the first cobbled-together responses to the euro crisis, its politicians wanted nothing to do with Greece's latest travails.

As a workaround, the EU's civil service drafted plans to protect the non-euro countries with collateral on the off-chance that disaster struck while the loan was in place. To shield euro area taxpayers from potentially footing the collateral bill, the loan was based on central bank profits from holdings of Greek bonds, which had been promised to Greece and could be rerouted to cover an unexpected loss. This broke an impasse between the UK and the euro area.

As it happens, the ESM has been a central part of managing these profits since the Eurogroup agreed to set them aside for Greece. In 2013, Jasper Aerts, an ESM legal officer who would later become deputy general counsel, helped design the system for the ESM to hold and monitor these funds. The firewall has worked closely on the use of these funds with euro area member states and the ECB over the years, as well as on this detail of the bridge loan. 'Both at the back and in the front, the ESM was involved in this innovative piece of financial engineering,' Aerts said.

Once the EU Member States approved the bridge loan to Greece, the EFSM's next task was to line up financing on capital markets. The Commission's fund was designed to borrow from the markets, but it did not have a large liquidity pool on-hand and was not a regular large issuer of bonds. How would it raise €7 billion virtually overnight? The answer came from the ESM putting together a massive short-term private placement.

'We could help in such a tight situation in a way that one might not have expected,' said ESM Managing Director Regling. 'We could help and were willing to do that within our standard framework.'

³⁵⁰ *Financial Times* (2015), 'UK angered by moves to help fund Greek bailout', 13 July 2015. <https://www.ft.com/content/0c789340-296a-11e5-acfb-cbd2e1c81cca>

Under ESM guidelines, the firewall is required to invest in high-quality, short-term securities to preserve and protect its permanent capital. Since the EFSM enjoyed the exemplary credit reputation of the entire EU, which had ratings equivalent to AAA from Moody's and Fitch, its debt was eligible for ESM investments under the firewall's strict investment guidelines. This allowed the ESM to offer the funds quickly, sparing the EFSM a last-minute scramble for financing from the market. And it allowed Europe to focus on the key task at hand, instead of worrying where the short-term financing would come from.

~ For more on the bridge loan, see 'Focus – An unusual money market transaction' later in this chapter.

On 16 July, the Eurogroup endorsed the third rescue programme in principle³⁵¹. A day later, the 28-strong EU approved the bridge loan, with a term of up to three months³⁵². Greece then used the money to pay the ECB on time and clear its arrears with the IMF.

The ESM's role in the transaction didn't become public until September, when it was reported in the media³⁵³. By that time Greece had repaid the money, and the firewall's unusual step of showing up on both sides of the balance sheet no longer made the waves it would have in the heat of the moment. It was one of the ESM's most important contributions to the funding chain, and one of its most unsung.

Regling said there was 'zero doubt' that the ESM was in a position to extend the financing that would, in turn, allow the three-week bridge loan to go forward.

'It was certainly something exceptional – we don't usually invest €7 billion in a single week,' he said. 'We used the scope that we had because it was in everyone's interest. It was in our interest, as Greece's largest creditor, that the country get out of this status of a "defaulting" country.'

³⁵¹ Eurogroup statement on Greece, Press release, 16 July 2015.

<http://www.consilium.europa.eu/en/press/press-releases/2015/07/16/eurogroup-statement-greece/>

³⁵² EFSM: Council approves €7bn bridge loan to Greece, Press release, 17 July 2015.

<https://www.consilium.europa.eu/en/press/press-releases/2015/07/17/efsm-bridge-loan-greece/>

³⁵³ Bloomberg (2015), 'EU squeezed \$7.8 billion Greek bridge loan via ESM loophole', 8 September 2015.

<https://www.bloomberg.com/news/articles/2015-09-08/eu-squeezed-7-8-billion-greece-bridge-loan-through-esm-loophole>

Third Greek programme (2015–2018)

-  **Initial programme amount:** €86 billion
-  **Total amount disbursed:** €61.9 billion
-  **Lender:** ESM
-  **Final weighted average maturity:** 32.35 years
-  **Key legislated reforms:** value added tax, income tax, pension system, insolvency law, out-of-court debt workout, sales and servicing of loans (NPLs), public revenue collection, product markets, management of state assets, public administration, social protection

After a three-week shutdown, Greek banks reopened on 20 July³⁵⁴. The capital controls remained in place, but getting the banks open again was a crucial step towards restoring Greek financial stability.

Greece's third euro area financial assistance programme was finally approved on 14 August 2015³⁵⁵. It envisaged a financing envelope of up to €86 billion, including up to €25 billion to recapitalise the banks and a cushion for unexpected needs. In contrast to past programmes, in which the ESM had played a supporting role, the firewall became an active participant in the negotiations.

'It was a logical step for the ESM to become closely involved in the negotiations concerning financial support,' former Eurogroup chief Dijsselbloem said. 'The knowledge and expertise on beneficiary countries and on financial markets, as well as the specifics of the ESM toolkit are valuable in discussions on the implementation of support programmes.'

For its part, the IMF stepped back. Voicing concerns about Greece's long-term debt outlook, the IMF declined to contribute financially to

³⁵⁴ UK, Government website (2015), 'Greece updates: advice for UK citizens and businesses', 29 June 2015.

<https://www.gov.uk/government/news/greece-updates-advice-for-uk-citizens-and-businesses>

³⁵⁵ Eurogroup statement on the ESM programme for Greece, Press release, 14 August 2015.

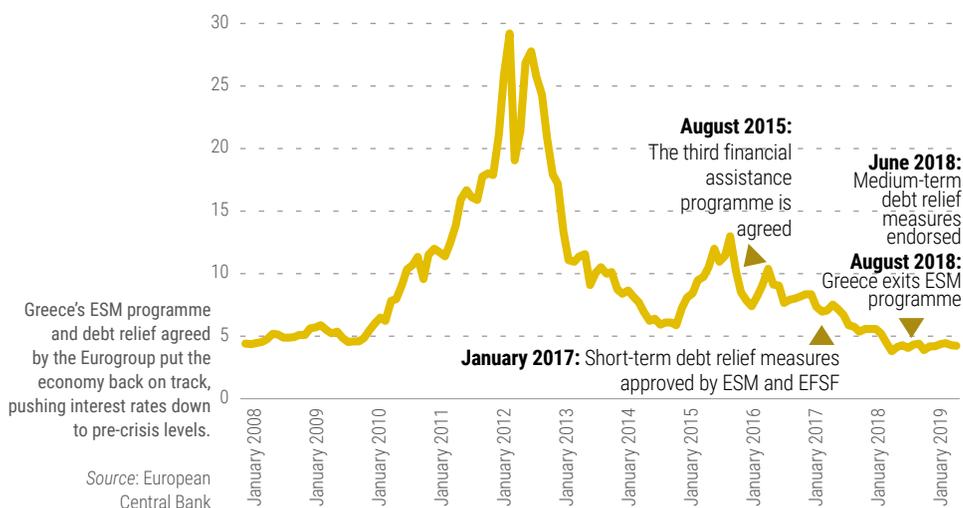
<http://www.consilium.europa.eu/en/press/press-releases/2015/08/14/eurogroup-statement/>

the third programme, although it would later, in 2017, agree to a stand-by arrangement to be in place through the end of the ESM package³⁵⁶.

On 18 August 2015, Greece began to reap market benefits, earning a Fitch upgrade to CCC from CC. On 20 August³⁵⁷, the ESM approved the first programme tranche, a €26 billion lump sum that included €10 billion for the banks and money to pay back the bridge loan³⁵⁸. Securing the payouts from this tranche would be another tightly managed process, contingent on Greece carrying out reform pledges over time. Greece got €13 billion in August to meet its immediate cash needs and the bank money held in reserve to be made available upon request, subject to approval by the ESM Board of Directors.

10-year government bond yield – Greece

in %, monthly average



³⁵⁶ IMF (2017), 'Greece: Request for stand-by arrangement – press release; staff report; and statement by the executive director for Greece', 20 July 2017.

<https://www.imf.org/en/Publications/CR/Issues/2017/07/20/Greece-Request-for-Stand-By-Arrangement-Press-Release-Staff-Report-and-Statement-by-the-45110>

³⁵⁷ Reuters (2015), 'UPDATE 1-Fitch upgrades Greece to 'CCC' after new bailout agreed', 18 August 2015. <https://www.reuters.com/article/eurozone-greece-ratings-idUSL3N10T52X20150818>

³⁵⁸ ESM (2015), 'ESM Board of Directors approves first loan tranche of €26 bn for Greece', Press release, 20 August 2015. <https://www.esm.europa.eu/press-releases/esm-board-directors-approves-first-loan-tranche-€26-bn-greece>;

ESM (2015), 'ESM Board of Governors approves ESM programme for Greece', Press release, 19 August 2015. <https://www.esm.europa.eu/press-releases/esm-board-governors-approves-esm-programme-greece>

From the beginning, the euro area didn't expect Greece to need all €86 billion in aid. For one thing, the currency union was counting on Greece eventually striking a new deal with the IMF. For another, the €25 billion envelope for the banks was an upper-end estimate. Experts including the ESM were convinced it would be a lot less, but Europe was determined to stay ahead of the markets.

'We established this envelope of €25 billion, but without expecting that there would be anything like that amount required,' said Hesketh, of the ESM's banking department. 'The worst thing to do is to come back and ask for more money.'

The ECB's stress tests turned up a total shortfall of €14.4 billion in October under the adverse scenario but, in the end, Greek banks didn't use up their initial €10 billion tranche. All of the four systemic banks were able to raise private capital, as two covered their capital needs entirely and €5.4 billion of ESM funds covered the residual needs of the other two³⁵⁹.

With the banks back in business and in better health, Greece began to find some stability. In September, parliamentary elections confirmed Syriza as the leading party, providing much-needed political continuity.

Greece implemented sufficient reforms to obtain a €2 billion disbursement from the remaining general-purpose funds in its approved tranche in November, and it also moved ahead with the bank recapitalisation³⁶⁰. Of the two banks that required ESM assistance, Piraeus Bank received €2.7 billion on 1 December³⁶¹ and National Bank of Greece received a very similar sum a week later³⁶².

It was important for the Greek bank recapitalisation to take place before new European bank rescue rules went fully into force at the start of 2016. The new rules, known as the bank recovery and resolution directive, specify the circumstances in which public funds can be used to assist banks in distress. A core principle of the directive is that public

³⁵⁹ ECB (2015), 'ECB finds total capital shortfall of €14.4 billion for four significant Greek banks', Press release, 31 October 2015.

<https://www.bankingsupervision.europa.eu/press/pr/date/2015/html/sr151031.en.html>;
ESM (n.d.), 'Greece – financial assistance' <https://www.esm.europa.eu/assistance/greece>

³⁶⁰ ESM (2015), 'ESM Board of Directors approves €2 billion disbursement to Greece', Press release, 23 November 2015. <https://www.esm.europa.eu/press-releases/esm-board-directors-approves-%E2%82%AC2-billion-disbursement-greece>

³⁶¹ ESM (2015), 'ESM Board of Directors approves €2.72 billion disbursement to recapitalise Piraeus Bank', Press release, 1 December 2015. <https://www.esm.europa.eu/press-releases/esm-board-directors-approves-%E2%82%AC2.72-billion-disbursement-recapitalise-piraeus-bank>

³⁶² ESM (2015), 'ESM Board of Directors approves €2.71 billion disbursement to recapitalise National Bank of Greece', Press release, 8 December 2015, <https://www.esm.europa.eu/press-releases/esm-board-directors-approves-%E2%82%AC2.71-billion-disbursement-recapitalise-national-bank>

funds cannot be used before a minimum of 8% of the bank's liabilities are bailed in to cover capital shortfalls.

The Greek banks had very few liabilities outstanding following the private sector involvement of 2012, meaning they would have had to bail-in uncovered deposits of more than €100,000 to achieve the minimum bail-in requirement. As these deposits were mainly held by small businesses rather than rich individuals, there was a strong concern that in this case bail-in could be financially destabilising for the economy and counter productive.

The flexibility of the older framework meant that Greek banks had an extra safeguard when they went to the markets to raise capital. Had the recapitalisation effort failed, the banks might have been able to work with regulators more flexibly than under the rigid structure that would be required later on.

Greece obtained another €1 billion of the first tranche in late December 2015³⁶³. From there, Greece tackled reforms step by step, winning approval in May 2016 for a €10.3 billion second tranche and in June 2017 for a third tranche of €8.5 billion³⁶⁴. Greece also regained favour with the IMF, thanks to its reforms and Eurogroup pledges of future debt relief. The IMF approved in principle a €1.6 billion stand-by arrangement³⁶⁵, although it ran until 31 August 2018 without Greece drawing on it because of ongoing IMF concern over debt sustainability.

When Greece unlocked a disbursement in March 2018, it was hailed as a sign that the programme would conclude on a high note. Valdis Dombrovskis, the European Commission's vice president for the euro and social dialogue, said the step strengthened confidence in the Greek economy. 'Moving closer to the end of programme, Greece's interest is to show that it has reached the point of no return',³⁶⁶ he said.

³⁶³ ESM (n.d.), 'Greece – financial assistance'. <https://www.esm.europa.eu/assistance/greece>; Germany, Federal Government (n.d.), 'Go-ahead for the second tranche of loans'. https://www.bundesregierung.de/Content/EN/Artikel/2016/05_en/2016-05-24-eurogruppe-einigung-griechenland-zweite-tranche-kredite_en.html

³⁶⁴ European Commission (2016), 'Compliance report: The third economic adjustment programme for Greece – first review', 9 June 2016. https://ec.europa.eu/info/sites/info/files/cr_full_to_ewg_en1.pdf; ESM (2017), 'ESM Board of Directors approves €8.5 billion loan tranche to Greece', Press release, 7 July 2017. <https://www.esm.europa.eu/press-releases/esm-board-directors-approves-%E2%82%AC85-billion-loan-tranche-greece>

³⁶⁵ IMF (2017), 'IMF executive board approves in principle €1.6 billion stand-by arrangement for Greece', Press release, 20 July 2017. <https://www.imf.org/en/News/Articles/2017/07/20/pr17294-greece-imf-executive-board-approves-in-principle-stand-by-arrangement>

³⁶⁶ Dombrovskis, V. (2018), Tweet, 27 March 2018. <https://twitter.com/vdombrovskis/status/978604388766937089?s=12>

As the programme wound down, Greece twice tapped the bond market, burnishing its credibility with investors. On 25 July 2017, it raised funds on the market for the first time in three years, selling €3 billion in 5-year bonds³⁶⁷. Greece borrowed another €3 billion with the sale of 7-year bonds on 8 February 2018.

‘Greece’s approach is what we’ve seen in the other countries that went through a programme – they did not wait until the last day of the programme to return to the market,’ Regling said. ‘After so many years of market absence, it’s important to go back slowly’³⁶⁸.

In parallel, the Greek government gradually loosened the capital controls it had imposed in June 2015 to prevent money from draining out of the country.

Greece’s cumulative efforts over eight years – topped off by 450 policy steps during the ESM programme alone, as tallied by the Portuguese finance minister, Mário Centeno, who took over as head of the Eurogroup in January 2018 – led to a 22 June 2018 Eurogroup declaration that the country would soon be on its own again.

At a conclusive meeting in Luxembourg, euro area finance ministers welcomed Greece’s completion of 88 final policy actions, accepted Greece’s commitment to further fiscal and structural reforms, authorised a final ESM disbursement, and came through with previously promised medium-term debt relief for Greece.

The wrapping up of the programme was the occasion for relief and reflection, mingled with self-criticism. ‘We have managed to deliver a soft landing of this long and difficult adjustment,’ Centeno told a press conference³⁶⁹. ‘There will be no follow-up programme in Greece.’

In a later interview with Spiegel Online, Regling looked back at the crisis management learning curve. ‘It would be arrogant to say we did everything right in Greece,’ he said. ‘There was no script for this crisis, the worst since the Great Depression’³⁷⁰. He said that a decision to conduct

³⁶⁷ Greece, Prime Minister’s Office (2017), ‘Issuance of a Hellenic Republic government bond’, Press release, 24 July 2017. <https://primeminister.gr/en/2017/07/24/18369>

³⁶⁸ For a fuller assessment of how four programme countries approached the restoration of market access, see Strauch, R., Rojas, J., O’Connor, F., Casalinho, C., de Ramón-Lapa Clausen, P., Kalozois, P. (2016), *Accessing sovereign markets: The recent experiences of Ireland, Portugal, Spain, and Cyprus*, ESM, Discussion Paper 2, 20 June 2016. <https://www.esm.europa.eu/sites/default/files/esmdp2final.pdf>

³⁶⁹ ‘Eurogroup press conference of 22 June 2018’, Video, 22 June 2018. <https://video.consilium.europa.eu/en/webcast/a71523e7-b839-4931-9f5b-ae7cf93ad00a>

³⁷⁰ Spiegel Online (2018), ‘Klaus Regling in interview with Spiegel Online’, 14 August 2018, ESM English translation, available at: <https://www.esm.europa.eu/interviews/klaus-regling-interview-spiegel-online>

the bond writedowns earlier, instead of waiting until 2012, could have subdued the crisis more quickly. Regling also expressed appreciation for the Greeks' self-sacrifice in order to stay in the euro area, saying: 'I wish that this adjustment was more appreciated in Germany.'

On 6 August 2018, the ESM made its fifth and final disbursement to Greece, a sum of €15 billion to be used for debt service and the build-up of the government's cash reserve³⁷¹.

When the programme formally ended on 20 August 2018, Greece was projected to have €24 billion in cash, enough to cover around 22 months of the government's financing needs – and giving it more time to cultivate the confidence of market investors.

During the three-year programme, Greece borrowed €61.9 billion from the ESM, well below the maximum €86 billion that had been authorised by the ESM Board of Governors. Combined with earlier support of €52.9 billion from the Greek Loan Facility and €141.8 billion from the EFSF, plus €32.1 billion from the IMF in parallel with those two programmes, Greece obtained emergency loans worth about €289 billion over eight years, a sum without parallel in modern financial history.

Greece has made significant progress, said Camilleri, Malta's representative in the working group of finance ministry deputies, hailing the reforms undertaken in recent years. At the same time, he said, the Greek government and the institutions still need to tackle many issues and to address the social dimension of the adjustment, showing that the situation remains grey instead of black or white. 'That is where the worth of the institutions and matching governments really have to withstand a very real and significant test – when you're faced with significantly more difficult issues and challenges,' Camilleri said. 'Let's not forget the people, because ultimately every adjustment programme has a human face.'

A host of statistics document Greece's progress from the early depths of the crisis. An economy that shrank 5.5% in 2010 grew 1.4% in 2017; a budget deficit of 15.1% in 2009 turned into a surplus of 0.8% in 2017; the current account deficit narrowed from 12.5% in 2009 to 0.9% in 2017.

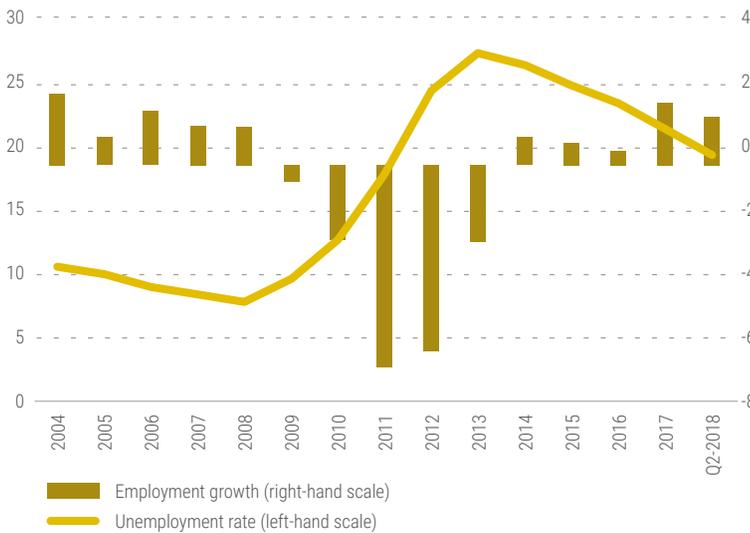
Employment, always a lagging indicator, gradually turned the corner, although the improvement was partly due to emigration and declining workforce participation. Rising joblessness was, in part, a direct but

³⁷¹ ESM (2018), 'ESM disburses final loan tranche of €15 billion to Greece', Press release, 6 August 2018. <https://www.esm.europa.eu/press-releases/esm-disburses-final-loan-tranche-€15-billion-greece>

unavoidable result of the reforms that were essential to modernising Greece's economy. In order to clean up its finances, the government cut the number of civil servants by 18% between 2009 and 2015³⁷². The jobless rate peaked at an average of 27.5% in 2013 and in the first half of 2018 had fallen to 19.5%.

Unemployment rate and employment growth – Greece

in %



Greece's unemployment rate peaked in 2013, and then declined steadily as economic reforms bore fruit.

Source: Eurostat

In a speech to the European Parliament on 11 September 2018, Prime Minister Tsipras summed up Greece's transformation. Greece 'is a different country,' he said. 'Today we stand on our feet once more and look towards the future with optimism. We escaped the spiral of recession and brought the economy back on track towards growth'³⁷³.

For the future, Greece has pledged to continue its policy of budgetary rigour, committing to a primary surplus of 3.5% of GDP until 2022 and around 2.2% from 2023³⁷⁴. Efforts must continue to strengthen

³⁷² Eurofound (2016), 'Greece: Reducing the number of public servants – latest developments.' <https://www.eurofound.europa.eu/el/publications/article/2016/greece-reducing-the-number-of-public-servants-latest-developments>

³⁷³ Greece, Prime Minister's Office (2018), 'We need a new social contract for social cohesion and the prosperity of our peoples,' Speech by Prime Minister Alexis Tsipras, in the plenary session of the European Parliament on the future of Europe, 11 September 2018. <https://primeminister.gr/en/2018/09/11/20532>

³⁷⁴ ESM (2018), 'Explainer on ESM and EFSF financial assistance for Greece,' 20 August 2018. <https://www.esm.europa.eu/assistance/greece/explainer-esm-and-efsf-financial-assistance-greece>

bank balance sheets, render the public administration more efficient, and foster a business-friendly environment. Greece will remain under the full scrutiny of the ESM until all loans have been repaid.

‘Greece will not be on its own,’ Regling said in a video message on the day Greece regained its financial independence³⁷⁵. ‘The ESM will be a long-term partner of Greece. We have an interest that the Greek economy does well in the future.’

Focus

An unusual money market transaction

When the EU’s emergency funding vehicle, the EFSM, was authorised to provide a bridge loan to Greece, it had a top credit rating but virtually no time to raise the money on the financial markets. ‘We arranged the private placement with a very small team between the ESM and the Commission. In the end, the spirit and cooperation were exceptional,’ said ESM General Counsel Eatough.

ESM Head of Investment and Treasury Lévy remembers intense brainstorming leading up to the operation: ‘This question arose of whether we could provide €7 billion at very short notice!’ The investment team worked out the mechanics of the transaction, while the political negotiations on the bridge financing details proceeded. The EU was already on the authorised issuer list for ESM investments, and the ESM was a regular buyer of EU bonds in the market. However, investing in a private placement entailed additional logistical complications, from crafting and signing a bilateral legal agreement with the EU to making changes to the information technology system to process the transaction.

From a technical perspective, the ESM needed to decide which of its internal portfolios would be invested in the transaction and whether or not to split it into a series of tranches. Regling agreed it would be simpler and more effective to do it all in one operation.

³⁷⁵ ESM (2018), ‘Statement by Klaus Regling on the conclusion of the ESM programme for Greece,’ Video, 19 August 2018. <https://www.youtube.com/watch?v=5jtKFmC-Xms>

At one point, ESM experts wondered if the transaction was the right thing to do, but the alternative – leaving the EFSM looking elsewhere for funding as Greece teetered – was considered a greater risk. The ESM's investment management committee set extra conditions and conducted a thorough review, making sure the investment decisions could be validated by all senior ESM staff members.

'It was in July. There was a lot of stress around this operation,' Lévy said. 'Personally, I was concerned about the technical execution, because this was the biggest one-off, single-sum investment that we had ever done. So, to ensure that all aspects of the decision were taken into account, we had a full review process.'

The money market transaction, as it was eventually called, was finally underway.

On the technical side, talks between the ESM and the European Commission went smoothly. Market conditions posed a challenge, however, because short-term interest rates for an issuer like the European Commission were close to -0.20%, while the ESM was not permitted, at the time, to invest at an interest rate of less than 0%. The Commission accepted this as a condition because, even though its implied funding rate was negative, there were no readily available alternatives. The ESM also offered an early repayment option – so, while the transaction had a maturity of three months, it could be paid back as soon as the bridge financing was no longer needed, which turned out to be a matter of weeks.

'We lent the money to the Commission, not Greece, and on the basis that it matched our own investment framework. We invested in EU paper and then we were repaid as soon as the money was unlocked,' Eatough said. 'If we hadn't succeeded, it would have been game over.'

Tight timing was a hallmark of the operation. 'We got the green light very late,' Lévy said. 'The money was needed on a Monday morning, but by Friday we still didn't know whether or not the EFSM bridge loan to Greece would be approved. All of the contracts were ready and the weekend approaching, but we were not authorised to sign the documents. Luckily both the European Commission and the ESM have offices in Luxembourg.'

In the end, one of the institutions signed on the Friday night and the second one over the weekend, to make sure the effective date matched the political agreements. One of the ESM's lawyers went to collect the signatures.

'We took pictures with the contract signed on that day, because it was a big thing,' Lévy said. 'It was very exciting; we knew we were involved in something important.'

When the time came to input the amounts and account numbers into the system, there was no room for error. The ESM had to send money to the EFSM, the EFSM had to forward it to Greece, and then Greece had to make the crucial payment to the ECB. Martins was the investment team member tasked with entering the trade in the system, outside the ESM's normal business hours.

'We had to make sure the system was open earlier than usual, that we had front office managers, back office managers, and middle office managers there first thing in the morning,' Lévy said. 'As I recall, Carlos arrived at 7.00, because we needed all of the operations to be done by 8.00 or 8.30. I distinctly remember Carlos meticulously checking the screens to make sure he had all the numbers right.'

Martins knew it was a momentous step. 'That day, that time, I decided to not simply double-check – as I usually do – but to triple-check the zeros in the transfer amount, as I was fully aware that another important page of the ESM was being written right there. And so I clicked to finalise the transfer.'

- ~ Greek programme history, which began in Chapters 3, 19, 22, and 36, continues in Chapter 38.

Debt relief: 'real savings for Greece'

38

A sober look at the facts shows that Greece's debt situation does not have to be cause for alarm. We would not have lent this amount if we did not think we would get our money back. Of course, reforms must continue.

Klaus Regling

ESM Managing Director and EFSF Chief Executive Officer

Greece emerged from its programme in August 2018 with outstanding debt of €190.8 billion to the euro area rescue funds. As holders of 53.2% of Greek central government debt at the end of 2018³⁷⁶, the EFSF and ESM are by far the country's largest creditors. Since the latest debt relief measures agreed in June 2018, the last EFSF loans are not scheduled to be retired until 2070, making Greece the longest-term partner of the firewall.

Managing and paying down debt until then – through economic and interest rate cycles that are beyond any reasonable forecasting horizon – will pose a generational challenge for Greek society. It is

³⁷⁶ Greece (2018), 'Hellenic Republic public debt bulletin', No. 92, December 2018.
www.pdma.gr/attachments/article/2048/Bulletin%20No_92.pdf

worth noting, however, that without the burden-sharing policies put in place by European creditors – from the first interest rate abatements in March 2011 to the later relief offered by the Eurogroup – the debt would be higher. None of these money-saving steps breaks with euro area strictures that require Greece to repay the principal amount of the loans in full.

Total budget savings for all programme countries

in % of GDP

	2011	2012	2013	2014	2015	2016	2017	2018
Ireland	0.1	0.3	0.3	0.3	0.3	0.3	0.3	0.2
Greece	0.0	1.6	4.1	5.0	5.2	6.2	6.6	7.0
EFSF	0.0	1.6	3.7	4.3	4.4	4.7	5.0	5.0
Deferred interest	0.0	0.0	0.4	0.7	0.7	0.7	0.6	0.7
ESM	0.0	0.0	0.0	0.0	0.2	0.8	1.1	1.3
Spain	0.0	0.0	0.2	0.2	0.2	0.2	0.2	0.1
Cyprus	0.0	0.0	0.7	1.6	1.9	2.0	2.0	1.9
Portugal	0.1	0.4	0.6	0.7	0.7	0.7	0.7	0.7

While every programme country saved money by borrowing from the rescue funds, Greece was the leading beneficiary.

Note: The ESM estimates these savings by comparing the effective interest rate payments on ESM and EFSF loans with the interest payments these countries would have paid had they covered their financing needs in the market. First, we estimate the direct budget savings per disbursement by comparing the ESM and EFSF rate to the 10-year bond yield, used as a proxy long-term market rate. We apply a cap of 6.4% on market rates, which from experience of the crisis suggests significant market stress and imminent loss of market access. Second, we calculate the indirect benefits. For each disbursement, the ESM calculates the gains from the previous year's reduced financing needs, making the same market rate assumptions as for direct budget savings.

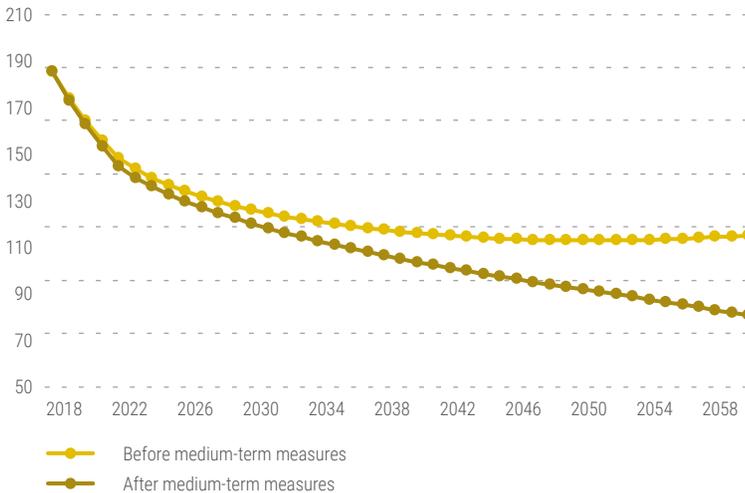
Source: ESM calculations based on ECB and Eurostat data

‘When I look at what happened in the past, it’s quite significant that not everybody may be aware how much debt relief has already been granted by private and official creditors,’ ESM Managing Director Regling said. ‘These are real savings every year, and a very large amount of money. It may not be so evidently visible, but it’s really there, and therefore the debt service in the Greek budget, in terms of GDP, is less than in many other countries.’

To be sure, the debate over Greek debt sustainability looks set to continue. The IMF declined to take part in the third programme out of concern over Greece’s debt, pressing the European creditors for more concessionary terms. In the final weeks of the programme, the IMF hailed Greece’s budget-cutting efforts and virtual elimination of economic imbalances, while remaining unconvinced about the long-term debt-repayment outlook. Relief offered by European creditors ‘has significantly improved debt sustainability over the medium term, but longer-term prospects remain uncertain,’ the IMF said in an assessment published on 29 June 2018, just after the latest Eurogroup debt relief agreement³⁷⁷. ‘[I]t could be difficult to sustain market access over the longer run without further debt relief.’

Debt-to-GDP projections – Greece

in %



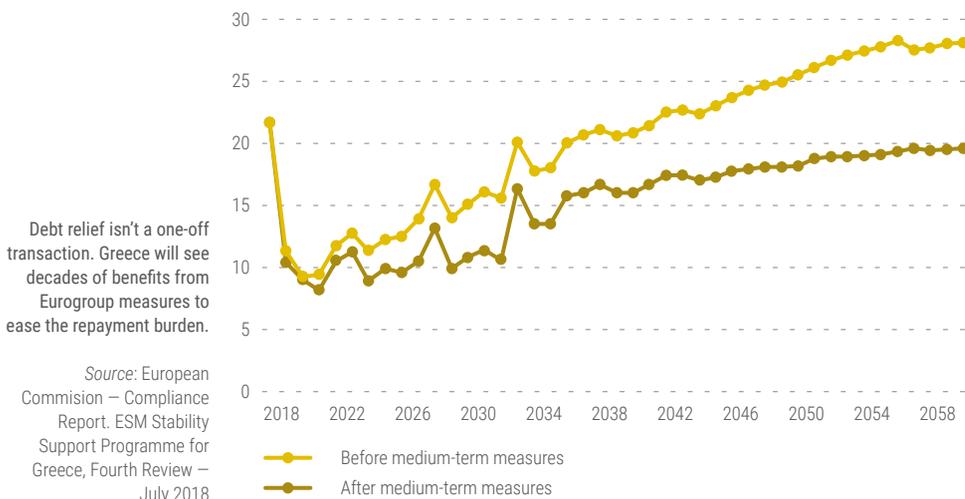
Greece is reaping significant savings from debt-relief measures offered by the Eurogroup.

Source: European Commission – Compliance Report. ESM Stability Support Programme for Greece, Fourth Review – July 2018

³⁷⁷ IMF (2018), ‘Greece: Staff concluding statement of the 2018 Article IV mission’, 29 June 2018. <https://www.imf.org/en/News/Articles/2018/06/28/ms062918-greece-staff-concluding-statement-of-the-2018-article-iv-mission>

Gross financing needs-to-GDP projections – Greece

in %



From the ESM's perspective, what matters is that the debt sustainability analysis (DSA) by European institutions concluded in June 2018 that Greece's gross financing needs will remain manageable³⁷⁸. The DSA is conditional on Greece receiving additional savings from the medium-term debt relief measures and on Greece following through on its economic commitments.

'We can safely say based on the DSA of the institutions that Greek debt is sustainable going forward,' Eurogroup chief Centeno told reporters after the finance ministers met in June 2018³⁷⁹.

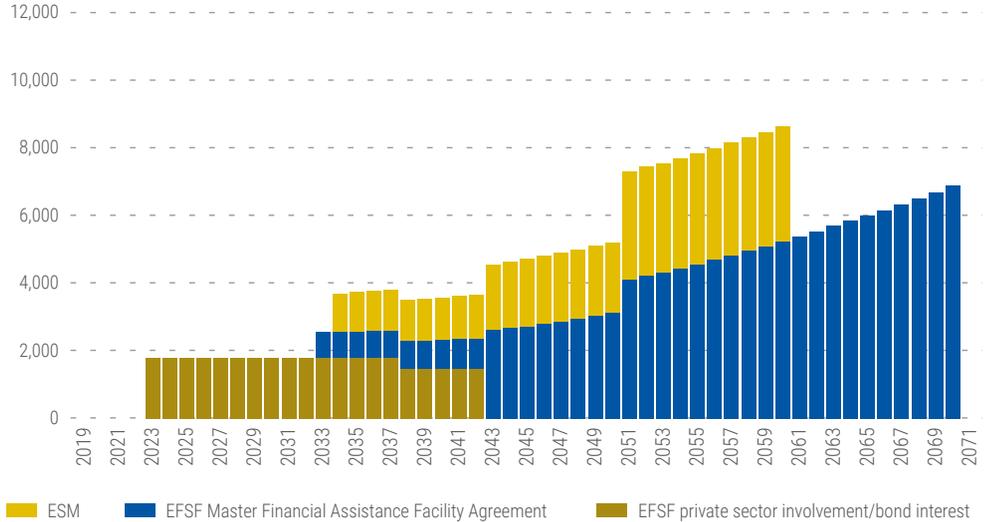
³⁷⁸ Eurogroup statement on Greece of 22 June 2018, 22 June 2018. <https://www.consilium.europa.eu/en/press/press-releases/2018/06/22/eurogroup-statement-on-greece-22-june-2018/>

³⁷⁹ Eurogroup (2018), 'Main results', 21 June 2018.

<https://www.consilium.europa.eu/en/meetings/eurogroup/2018/06/21/>

ESM/EFSF debt redemption profile – Greece

in € billion



Greece doesn't have to start paying down rescue loan principal until 2023, and the final instalment isn't due until 2070.

Source: ESM

EFSF and ESM loans to Greece have over 30 years average maturity – in some cases over 40 – and carry very favourable interest rates. ESM economists estimated that these advantageous conditions alone save Greece around €12 billion in debt servicing annually, which was equal to 6.7% of GDP in 2017³⁸⁰.

ESM expertise has been crucial in shaping and executing the relief policies, starting with short-term measures envisaged by the Eurogroup in May 2016 and carried out in 2017. The objective was to facilitate Greek access to the bond markets, spread out repayments over time, sustain Greece's economic adjustment once the programme ended, and insulate Greece from the interest rate increases in financial markets that are expected in the long term³⁸¹.

³⁸⁰ ESM (2018), 'Greece successfully concludes ESM programme', Press release, 20 August 2018. <https://www.esm.europa.eu/press-releases/greece-successfully-concludes-esm-programme>

³⁸¹ Eurogroup statement on Greece, Press release, 9 May 2016. <http://www.consilium.europa.eu/en/press/press-releases/2016/05/09/eg-statement-greece/>

‘The short-term debt measures will have a significant positive impact on the sustainability of Greek debt,’ the Eurogroup said in a 5 December 2016 announcement that entrusted implementation to the ESM³⁸². There was a last-minute hitch when Greece made some spending commitments without getting clearance from the institutions. The process resumed after Finance Minister Tsakalotos said in a 23 December 2016 letter to the ESM and Eurogroup that Greece was ‘fully committed to pursue the agreed fiscal path’³⁸³.

One feature of the short-term package was the use of a bond exchange scheme and interest rate derivatives to improve Greece’s debt sustainability and prevent future unexpected increases in the cost of its official loans, without additional costs to other programme countries. The bank recapitalisation component of the EFSF and ESM programmes, for example, had been financed with notes that came with floating interest rates. These short-term measures included an exchange of these floating-rate notes with funds backed by long-term fixed-rate issuances. For the ESM, there were also swap contracts implemented for some of the remaining ESM loan tranches, to peg Greece’s costs close to the historically low levels at which it borrowed during the crisis. These measures serve as a fiscal shield that make Greece’s budget planning more predictable.

Other measures at that time included bringing the weighted average maturity of Greece’s EFSF loans back up to the original 32.5 years and spacing out loan repayments due in the 2030s and 2040s. Creditors also waived for 2017 a scheduled ‘step-up’ interest rate margin of 200 basis points on an €11.3 billion tranche that had been connected to Greece’s debt buy-back in the second programme³⁸⁴.

Greece was benefiting from the first round of cost savings when, on 15 June 2017, euro area finance ministers sketched out the medium-term measures that would be on the table once the programme ended. Already, the Eurogroup noted in a statement, the short-term measures had contributed to a ‘substantial lowering’ of Greece’s gross financing needs and the smoothing out of its future payments trajectory³⁸⁵.

³⁸² Eurogroup statement on Greece, Press release, 5 December 2016.

<http://www.consilium.europa.eu/en/press/press-releases/2016/12/05/eurogroup-statement-greece/>

³⁸³ Greece, Ministry of Finance (2016), ‘Letter from Euclid Tsakalotos to Jeroen Dijsselbloem and Klaus Regling’, 23 December 2016. <http://www.tovima.gr/files/1/2016/12/27/TSAKALOTOS11.pdf>

³⁸⁴ Eurogroup statement on Greece, 5 December 2016.

<http://www.consilium.europa.eu/en/press/press-releases/2016/12/05/eurogroup-statement-greece/>

³⁸⁵ Eurogroup statement on Greece, 15 June 2017.

<http://www.consilium.europa.eu/en/press/press-releases/2017/06/15/eurogroup-statement-greece/>

The medium-term proposal was part of efforts encouraging Greece to stay the course of budgetary prudence and economic modernisation beyond the life of the programme. As proposed, it covered the elimination of the ‘step-up’ interest rate margin tied to the second programme debt buy-back instalment; the release of central bank profits on Greek securities withheld in 2014; the restoration of those profit transfers as of 2017; further ‘liability management operations’ within the ESM programme envelope; and the further extension of Greece’s EFSF maturities and deferral of interest payments, as long as this didn’t create an additional burden on the countries providing EFSF guarantees.

Eurogroup ministers pledged to carry out these medium-term measures ‘to the extent needed’ at the end of the programme, and left the door open to further adjustments if the Greek economy suffered another downside shock³⁸⁶. For the long term, ‘in the case of an unexpectedly more adverse scenario, a contingency mechanism on debt could be activated,’ the Eurogroup said. Steps could include further EFSF re-profiling, as well as capping or deferring interest payments.

By the summer of 2018, all the moving parts came together when the Eurogroup made good on medium-term pledges. The new debt relief for Greece was agreed to be a further 10-year deferral of interest and amortisation and a 10-year extension of the maximum weighted average maturity on €96.4 billion of EFSF loans, and the ‘step-up’ interest rate margin on the debt buy-back instalment was conditionally scrapped until 2022 and permanently thereafter.

Greece, which is projected to have had debt of 188.6% of GDP in 2018³⁸⁷, stands to reap considerable benefits. Building on the savings brought about by the short-term measures in 2017, the European institutions estimate that the medium-term measures of 2018 are likely to reduce Greece’s debt ratio by 30 percentage points in 2060, to 96.8% of GDP, and its gross financing needs by eight percentage points, to 19.8%³⁸⁸.

³⁸⁶ Ibid.

³⁸⁷ European Commission (2018), ‘Compliance report: ESM stability support programme for Greece – fourth review’, p. 42, 9 July 2018.

http://www.consilium.europa.eu/media/36299/compliance_report_4r_2018-06-20-docx.pdf

³⁸⁸ EFSF (2018), ‘EFSF approves medium-term debt relief measures for Greece’, Press release, 22 November 2018.

<https://www.esm.europa.eu/press-releases/approval-medium-term-debt-relief-measures-greece>

But it didn't end there: in a tribute to the long-term nature of Greece's financial commitments, the Eurogroup pledged to examine 'whether additional debt measures are needed' when Greece starts paying down the principal on its EFSF loans in 2032. And it underlined a willingness to intervene earlier if the Greek economy stumbled³⁸⁹.

There were, however, no giveaways. Greece will remain under surveillance by the Commission and ESM, and key features of the debt-relief package are contingent on the Greek government upholding its economic pledges. Greece's recovery of central bank profits from its bonds, for example, hinges on the fulfilment of a host of policy commitments made at the June 2018 Eurogroup meeting³⁹⁰.

Enhanced surveillance 'is appropriate, given the large amount of money that has been disbursed, and also the unprecedented debt relief,' Regling told the media after that meeting. 'Therefore, the post-programme monitoring is tighter than in the other cases'³⁹¹.

The ESM's view is that, as long as Greece remains fiscally prudent while shoring up the economy, the debt can be paid back on schedule. Eurogroup steps have eased Greece's debt repayments, but the ultimate success of the programme lies in the Greek government's continued reform implementation.

'It is very unusual to make such long-term plans. But it follows from the very unusual situation in Greece. No other country has ever received so much money from its partners,' Regling said. 'The amounts were unprecedented – this has never happened anywhere in the world before – and the terms were extremely favourable. We want to help Greece regain debt sustainability and we want Greece to have a strong, healthy economy, with good growth, where employment is returning and jobs are created.'

³⁸⁹ Eurogroup statement on Greece of 22 June 2018, Press release, 22 June 2018. <http://www.consilium.europa.eu/en/press/press-releases/2018/06/22/eurogroup-statement-on-greece-22-june-2018>

³⁹⁰ Specific commitments to ensure the continuity and completion of reforms adopted under the ESM programme, Annex to Eurogroup statement on Greece of 22 June 2018. http://www.consilium.europa.eu/media/35749/z-councils-council-configurations-ecofin-eurogroup-2018-180621-specific-commitments-to-ensure-the-continuity-and-completion-of-reforms-adopted-under-the-esm-programme_2.pdf

³⁹¹ ESM (2018), 'Klaus Regling at Eurogroup press conference,' Transcript, 22 June 2018. <https://www.esm.europa.eu/press-releases/klaus-regling-eurogroup-press-conference-9>

Beyond the troika: the ESM's evolving role

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The ESM's role has evolved into a full participant in monitoring the programmes, together with the European Commission, the ECB, and the IMF. With the crisis behind us, we are pursuing new, more effective ways of working together.

Klaus Regling

ESM Managing Director and EFSF Chief Executive Officer

During the crisis, the ESM grew to become one of Europe's established institutions with economic and financial expertise, offering a reliable safety net to the now 19 members of the monetary union. As the euro moves into its next stage of development, the firewall has earned its place at the table with its fellow international organisations.

The 'troika', as the initial group of three institutions was called, shared responsibility for preparing and monitoring the euro area rescue programmes. The European Commission worked closely with the ECB and the IMF to make sure the programmes would succeed.

As the ESM matured, it gained a seat at the crisis management table and it became an indispensable part of Europe's financial safety net. The firewall has always been able to tap financial markets to make sure aid programmes have ready cash to disburse when called upon.

Furthermore, from the early days, the rescue funds have used their day-to-day knowledge of the financial markets to inform the effort to help countries regain market access.

‘What was first a troika, became a quartet. Despite occasional differences of opinion, cooperation was good,’ Managing Director Regling said in an op-ed for the Greek newspaper *Kathimerini* in August 2018 as Greece’s ESM programme came to a close³⁹².

The ESM has been part of an effort to strengthen debt management standards for the euro area. In setting up the permanent firewall, countries pledged that they would include uniform collective action clauses in their future bonds, in a move to ensure these clauses would be applied throughout the euro area and have an identical legal impact across all members. Such clauses are now standard, a change that happened quickly and efficiently after the requirement was made part of the ESM Treaty. The precedent set by the clauses has since been recognised as a key reference point by the Court of Justice of the European Union³⁹³.

Through its funding and investment activities, constant contact with financial markets has made the ESM well placed to gauge reactions to the euro area’s crisis containment measures and to the reforms in borrowing countries. The firewall also has devised a system to monitor rescue loans over their entire lifetime, not just during the active phase of a rescue programme, in order to anticipate any repayment difficulties and to assess debt sustainability. The ESM also gained a strong knowledge of the banking sector, as banks played a critical role in every programme country’s crisis-fighting strategy. Taken together, these developments show the expertise the ESM has acquired since its creation.

Now, after the crisis, each of the institutions that fought the turmoil must assess and reflect on how it handled things. In the wake of this tumultuous period, each must decide how to prepare for the next disruption, which, inevitably and regrettably, will come someday.

As the euro enters its next era, the monetary union is reflecting on how it will work with the IMF going forward, how the ESM and the European Commission will best coordinate their roles, and how the Eurogroup sees the roles of the institutions evolving. On a parallel track, the ESM has led

³⁹² *Kathimerini* (2018), ‘Op-ed by Klaus Regling’, Online article, 19 August 2018.

<https://www.esm.europa.eu/interviews/op-ed-klaus-regling-kathimerini-greece>

³⁹³ CJEU (2018), ‘Judgment in Case C-308/17 Leo Kuhn v Hellenic Republic’, Press release 177/18, 15 November 2018.

<https://curia.europa.eu/jcms/upload/docs/application/pdf/2018-11/cp180177en.pdf>

a drive of regional rescue funds to enhance cooperation with each other and with the IMF, thereby strengthening the global safety net.

Looking back, the ESM and its fellow institutions found that personal relationships were essential for getting through the toughest moments of the euro crisis. Regling, who had held senior posts at the Commission, the IMF, and the German finance ministry, knew many of the individuals involved personally. As a result, the firewall made a contribution from its earliest days: the Commission's Buti said the EFSF quickly earned a reputation as an honest broker. 'The troika was uncomfortable for everybody. Every institution was uncomfortable,' he said. 'It was good to have Klaus there to help discipline the discussions.'

The other institutions also faced a learning curve, requiring negotiators to find solutions whenever possible and a way forward when differences of opinion remained, said the IMF's Lagarde.

'The confrontation of views was sometimes difficult and awkward. And people did not like it so much. But equally it enabled, and it required, the settling of differences until and unless differences could not be settled, which has happened on occasion,' Lagarde said.

A case in point was the argument between the Commission and the IMF over Greece's long-term financial viability. The ESM was seen as a trusted source of debt projections that could be used to shape responsible policies, helping craft a new approach that was acceptable to all, said former German Finance Minister Schäuble.

'It hasn't reinvented the wheel, but it has provided high-quality, well-informed input. Of particular note is its analysis of sustainability using a market-oriented approach,' Schäuble said.

Going forward, the ESM will inevitably take on a bigger role because of the global changes wrought by the last round of financial turmoil, said former US Treasury Secretary Geithner.

'We now live in a world where the capacity of central banks to provide a protection against the extreme threat is much diminished,' Geithner said. In his view, this is true of the US, Japan, and Europe but 'it matters more in Europe because of the immaturity of the fiscal arrangements and financial arrangements. It's likely to create more of a burden on governments and the collective funding mechanisms like the ESM.'

Within Europe, there's also a hope that the euro's rescue architecture can become strong enough to stand on its own. While the IMF's knowledge base will always be a valued partner, the euro area might benefit if, in the next crisis, it does not need to turn to outside funding.

A more self-reliant euro area would be a very good development for Europe if the political outlook shifts in a way to make that possible, said the European Commission's Verwey. 'I don't think it's healthy for the continent to permanently depend on support from an international institution. The goal must be to become independent,' Verwey said. 'With all the experience we now have, with all the institutions we have established, we are close to the moment when we can let go.'

A turning point came in 2018, when the ESM and the Commission reached a new understanding of how they will work together, in times of calm as well as times of crisis. The new course of collaboration means ESM's expertise will be put to broader use, following financing conditions not only in countries that have received aid, but also in countries outside the aid framework. In this way, the ESM will always be in position to work alongside the Commission to design a new programme on short notice, if needed.

'The close collaboration between the Commission and the ESM in recent years has demonstrated that we can act successfully and with determination in the interest of the euro area in times of crisis',³⁹⁴ said Pierre Moscovici, European commissioner for economic and financial affairs, taxation and customs, when the move was announced. 'By strengthening the foundations of our crisis management, we are sending a signal of confidence and stability.'

The agreement with the Commission took shape over the course of the year, beginning with a memorandum of understanding signed in April, laying out the foundations of the cooperation in line with how it had been evolved over recent years. As a result, the two institutions were also able to collaborate on a way forward, in light of the ESM's broader mandate. Euro area finance ministers sealed the deal at their December meeting, welcoming the agreement and setting the stage for EU leaders to take the next steps in augmenting euro area oversight. The deal paves the way for the Commission and the ESM to make the most of their respective expertise.

'We intend to work very closely together, particularly on debt issues and market access,' Regling said.

To cement their cooperation, the ESM and the Commission will meet informally at least twice a year to share assessments and analysis of

³⁹⁴ ESM (2018), 'European Commission and European Stability Mechanism lay down principles of cooperation', Press release, 27 April 2018. <https://www.esm.europa.eu/press-releases/european-commission-and-european-stability-mechanism-lay-down-principles-cooperation>



Sustainable fashions: IMF Managing Director Christine Lagarde sports an ESM T-shirt after a meeting with ESM Managing Director Klaus Regling in Luxembourg in 2015.

Credit: ESM

macro-financial risks. When it makes sense from a policy perspective, the ESM will also be invited to join Commission staff on their missions to member states³⁹⁵.

The two institutions also will work together to assess eligibility for precautionary credit lines, and to negotiate the aid conditions for any future assistance programmes. The ESM's role will focus specifically on analysing market access for countries considering an aid request, and it will play a central role in preparing the debt sustainability analysis that accompanies the consideration of a potential programme.

The ECB will continue to play its role among the institutions, the finance ministers said in endorsing the ESM-Commission agreement. The euro area also will continue to work with the IMF, although its role is likely to be less prominent than during the early crisis years.

The ESM is working with other regional financing arrangements (RFAs) to develop best practices for working on their own and in collaboration with the IMF, in order to strengthen the global financial

³⁹⁵ ESM (2018), 'Future cooperation between the European Commission and the European Stability Mechanism,' 14 November 2018. <https://www.consilium.europa.eu/media/37324/20181203-eg-1b-20181115-esm-ec-cooperation.pdf>

safety net³⁹⁶. Since October 2016, the RFAs have met annually at the IMF annual meetings, and they now engage in a regular dialogue throughout the year. The organisations also are working together on topics of common interest relevant to economic surveillance and crisis management. Shortly after its fifth anniversary in October 2017, the ESM signed formal agreements to reinforce collaboration in areas of common interest with Fondo Latinoamericano de Reservas (FLAR) and with the Association of Southeast Asian Nations+3 Macroeconomic Research Office (AMRO). Also in 2017, the IMF published its own policy on how it will exchange documents with the regional organisations.

The ESM and four of its fellow RFAs called for a more formal set of guidelines for how the IMF will work with the regions going forward, in an October 2018 joint discussion paper³⁹⁷. Such a framework could be particularly helpful in areas such as training, capacity building, and information sharing. The RFAs endorsed the IMF's proposal of a generally flexible approach to future collaboration, given the differences in activities and missions in each regional institution's part of the world. But they said that more details might be helpful in selected areas, such as how collaboration would work in 'the run-up to the crisis period' and how a regional institution might function as the lead agency on a rescue programme. The more planning takes place in non-crisis periods, the better the response will be when urgent action becomes necessary.

'The resolution of the euro area debt crisis provided a new field to test the collaboration between the regional institutions in Europe and the IMF,' the discussion paper said. The IMF worked hand in hand with the EU and the euro area on rescue design and aid negotiations, and also joined forces for reviews during and after aid programmes. The report said: 'Overall, this in-crisis collaboration worked well. However, it also shed light on the areas that would require future improvement.'

The IMF is also in the process of weighing its options. Lipsky, who was the IMF's deputy managing director and then acting managing director in the early phase of the crisis, said the euro area now has a rescue apparatus that could be rapidly expanded in an emergency. 'There's not a reason in the world, objectively, why Europe should need IMF funding to support a specific Member State,' Lipsky said. There might be a political need for the IMF to put some of its own funds on

³⁹⁶ Arab Monetary Fund, AMRO, Eurasian Fund for Stabilization and Development, European Commission, ESM, FLAR (2018), 'IMF-RFA collaboration: Motives, state of play, and way forward: A joint RFA staff proposal', Discussion Paper 4 - special issue, October 2018. <https://www.esm.europa.eu/sites/default/files/esmdiscussionpaper4.pdf>

³⁹⁷ Ibid.

the line as an endorsement of Europe's efforts, but 'in objective terms, I can't see – except in the most exceptional circumstances – that there would be a need in the future for IMF funding in the euro area.'

This approach reflects a change in outlook among the IMF membership over the course of the crisis. As the euro crisis neared its peak, the international lender came under pressure from its non-European members to limit its lending to wealthy euro area countries, and divisions over Greece led it to scale back further the prospect of additional lending to that country. This backlash over the IMF's successive – and successively smaller – interventions in Europe has changed the outlook for future cooperation, particularly now that Europe has a robust permanent firewall.

The joint discussion paper from the RFAs highlights the political advantages of working with the IMF. In some cases, regions 'may need to rely on the IMF to alleviate moral hazard risks given that IMF lending tends to come with policy adjustment.'

This view is shared by many ESM Members. 'The IMF's involvement in the completed programmes for Ireland, Cyprus, and Portugal clearly improved the quality of the programmes. These successes speak for themselves,' Schäuble said. 'It is also better for Greece if its transformation into a more robust economy is supported by the IMF. In Germany, the IMF's participation increases political support for the Greek rescue package.'

Former programme countries are less keen, however, as they view the IMF to be overly focused on financial targets and not sufficiently sensitive to the wider economic and social impact of economic reforms. Greece welcomed the IMF for its first rescue programme, in 2010, before a euro area support mechanism existed. By 2015, when Greece was negotiating the third programme with the permanent ESM, many Greeks saw the IMF as unduly critical and out of touch. When asked if popular acceptance of the programme was made easier because the IMF didn't participate financially, Greece's Stournaras said: 'Yes. Absolutely.'

The Eurogroup has sought to take stock of the range of views among its membership and of the ESM's overall performance in its first years of existence. To this end, it commissioned an evaluation conducted by former Austrian central banker Gertrude Tumpel-Gugerell, a member of the ECB's Executive Board from 2003 to 2011. The evaluation was released in mid-2017 after more than a year of work.

The report said the ESM should urge countries that are requesting aid to take stronger ownership of required conditions, in order to make

aid programmes more credible³⁹⁸. It said rescue programmes should be built with clear objectives and priorities in mind, so that beneficiary nations can return to market financing and adopt structural reforms on a practical schedule, and it said countries might benefit from seeking programmes earlier. 'The ESM should pre-empt delays in programme requests when problems cannot be effectively solved at national level,' the report said.

These recommendations cut across the wide range of public sentiment over when and how aid requests are appropriate. As Germany's Schäuble said, countries should avoid requesting aid unless they are truly in dire straits, and in general ESM aid is granted only as a last resort. Likewise, countries in trouble may not want to seek aid until they are sure they have exhausted every possible alternative.

'No government, no people would go for an adjustment package willingly. That is something I've seen,' Malta's Camilleri said. 'The cycles of all the different countries undergoing these adjustment packages – I mean, none of them walked in and signed on to a package very, very willingly. They all took great, great pains to avoid it, so let's not fool ourselves. I haven't seen one single country gallivanting wanting to go into some adjustment programme.'

But, once a country is on board with a programme, its reforms and helping hand can make a big difference. For example, Ireland won praise for accepting responsibility and embracing the necessary reform, said Giammarioli, the ESM's head of strategy and institutional relations, who was the rescue fund's Ireland country coordinator from 2013 to 2015.

In contrast, Greece faced a different set of constraints in combatting a crisis of a different magnitude. According to Greek Finance Minister Tsakalotos, Greece took some actions it strongly believed in, some it was unsure about, and some that were imposed on it by the international authorities. Because of the severity of Greece's problems, it had no choice but to comply even when it disagreed with the chosen policy, he said. 'If I was not a minister of finance of an indebted country, I would have done things differently. In my view, that would have been more socially just and actually more economically efficient.'

³⁹⁸ Tumpel-Gugerell, G. (2017), *EFSF/ESM financial assistance: Evaluation report*, Publications Office, Luxembourg. https://www.esm.europa.eu/sites/default/files/ti_pubpdf_dw0616055enn_pdfweb_20170607111409_0.pdf

All of these experiences have contributed to the euro area's next steps in mapping out its crisis-fighting system. The working methods within what are now widely called 'the institutions' will continue to adapt to euro area needs, while also serving as an example of IMF cooperation with regional organisations worldwide.

Lipton, the first deputy managing director of the IMF, said: 'I see it as a very valuable, new and imaginative collaboration and interaction, and think that we'll all be evaluating how that's worked, and how it might best work in the future, and how lessons from our interaction with the ESM could be used in shaping good modes of cooperation with other institutions and other regions.'

The ESM: taking on new tasks

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If we fail to implement the agenda to deepen the monetary union now, the next crisis will force us to do so. If we do what we know needs to be done, we have the potential to save jobs and economic heartache.

Klaus Regling

ESM Managing Director and EFSF Chief Executive Officer

Euro area countries forged a new shield for monetary union over the course of 2018, making the most of a period of reflection on how to deepen and strengthen their ties. Work that began in 2015 with the EU's 'Five Presidents' report³⁹⁹ progressed through a series of proposals that culminated in an important step to enhance Europe's Economic and Monetary Union.

European leaders, at a summit in December 2018, endorsed a wide-ranging push to deepen Economic and Monetary Union that broadens the ESM's mandate and will require euro area member states to change the treaty governing the firewall. The plan includes steps to adapt the

³⁹⁹ Juncker, J.-C., Tusk, D., Dijsselbloem, J., Draghi, M., Schulz, M. (2015), *Completing Europe's Economic and Monetary Union*, European Commission, 22 June 2015. https://ec.europa.eu/commission/publications/five-presidents-report-completing-europes-economic-and-monetary-union_en

firewall's toolkit, strengthen the way the firewall works with its fellow institutions, and create a backstop for helping the financial sector handle a major bank failure. When these steps are implemented, the firewall will become an important part of the euro area's banking union and it will continue to be a provider of last-resort financing for countries that lose their ability to borrow on private markets.

European Council President Tusk hailed the agreements on banking and crisis prevention: 'These two decisions – which mean changing the ESM Treaty as soon as possible – significantly strengthen the monetary union,' he said after the meeting⁴⁰⁰.

The December decisions showed the growing political support for the ESM from member states across the euro area, drawing support from countries that received aid as well as countries that had been sceptical of the whole process.

Slovakia, an early critic of the rescue funds, is now one of the voices calling for the ESM to play a central role in constructing a stronger euro area financial architecture. In 2016, Slovakia spearheaded a discussion on shock-absorbing mechanisms during its time at the helm of the EU's rotating presidency, and the country has since continued to advocate euro area integration.

The currency union needs institutions, rules, and instruments designed to fortify all of the euro area, in order to shield economies and financial sectors in the member states from harm, according to Slovak Finance Minister Peter Kažimír. 'We need to transform the ESM,' he said. 'What we need to achieve is a more resilient, better functioning euro area with a clear strategic direction.'

The firewall should be at the heart of the monetary union's next steps, said Albuquerque, former finance minister of Portugal, which was one of the pioneers in undergoing a rescue programme. 'We would like to see the evolution of the ESM as the central element of a new institutional framework inside Europe and particularly in the euro zone – clearly continuing to exist and becoming more relevant, with a bigger role than it has now,' she said. 'There is the need to create a different institutional framework making ESM evolve into something

⁴⁰⁰ Remarks by President Donald Tusk after the European Council and Euro summit meetings on 14 December 2018, Statement and remarks 799/18, 14 December 2018. <https://www.consilium.europa.eu/en/press/press-releases/2018/12/14/remarks-by-president-donald-tusk-after-the-european-council-and-eurosummit-meetings-on-14-december-2018/pdf>

that could be called European Monetary Fund or anything else. This is for lack of a better designation and so that people understand what we are talking about.’

In 2016, momentum was building towards strengthening the euro area. As former European Commissioner Rehn, now governor of the Bank of Finland, said at the time: ‘The future of the ESM is related to the overall reform of euro zone governance. We have to continue the reconstruction of the euro zone even though for the moment there is not much appetite for that because of several immediate pressing concerns.’

Heading into 2019, the appetite for positive change is much improved. The ESM is a well-established firewall, all euro area countries that received aid have exited their rescue programmes, and the banking union is off to a solid start. The next challenge will be to strengthen the foundations of the euro – to prepare for the next crisis before it hits instead of after the fact.

‘The European reaction to the crisis was arguably slow at first, but when you look back you see we have come a long way in filling in the holes of the initial set-up of the euro,’ said Centeno, chairman of the ESM Board of Governors and Eurogroup president. ‘In times of crisis, the temptation to look inwards is strong. But European governments agreed to pool resources at the ESM to defend our currency in a way that was unimaginable at the onset of the euro. That boosted confidence in our currency. No wonder the ESM became a beacon for further integration in the euro area.’

The achievements of 2018 bear this out. Over the course of the year, the euro area was able to break deadlock on a wide range of policy issues. The Eurogroup assembled all the elements of the deal in early December, meeting in an inclusive format that includes non-euro countries as well.

One of the biggest steps forward involves the euro area’s banking union, which began in 2012 when countries agreed to create a common bank supervisor to oversee cross-border, systemic banks – and to create a new framework for dismantling them safely if needed. The ESM has in parallel stood by to help safeguard the euro area’s financial sector, and now it stands poised to join forces formally with the banking union’s other main institutions.

Banking union depends on three main elements: supervision, resolution, and deposit insurance. The euro area has harmonised its rules on how countries must provide deposit insurance, and it created a pair of new institutions to handle the other duties: the Single Supervisory Mechanism to keep an eye on the big banks, and the Single Resolution Mechanism to stand ready to take them apart. To help prevent a liquidity crunch, the Single Resolution Board is collecting fees from banks to build up a resolution fund that can be tapped in an emergency. However, this fund on its own was not seen as a strong enough bulwark.

At the start of the euro area effort, the ESM was directed to develop the capacity to provide targeted aid to a country's financial sector, either by offering government aid with a banking focus or by stepping in to help banks directly. Between 2012 and 2014, the ESM made sure that all of its tools would be fully operational when called upon, and in the process it acquired substantial expertise. Once the heat of the crisis had passed, euro nations sought to harness these capabilities more fully.

In June 2018, euro area leaders struck a provisional deal for the ESM to take over permanent bank backstop duties, which had been temporarily assigned to a series of national credit lines. At that meeting, leaders also agreed to 'start on a roadmap for beginning political negotiations' on a European deposit insurance scheme, another important pillar of the banking union project⁴⁰¹. The speed at which this can be implemented will depend on the progress made by euro area governments in other areas, such as dealing with non-performing loans.

By December 2018, euro area resolve had solidified around the plan. The ESM and the European Commission had worked out how they will cooperate going forward, in times of calm as well as times of turmoil, and the euro area had also delved more deeply into the various proposals for shoring up the monetary union. Not only would the ESM take on a new role regarding banking, it also would take a fresh look at its lending toolkit to make sure it could offer the euro zone the best possible help.

'It was important for us to have a comprehensive reform, not only focusing on the operation of the ESM in connection with what's

⁴⁰¹ Euro summit meeting (29 June 2018) – Statement, 29 June 2018.
<https://www.consilium.europa.eu/media/35999/29-euro-summit-statement-en.pdf>

being called a backstop, but also encompassing things that will enable the ESM in the future to address debt sustainability and will see to it that the ESM's precautionary instruments can be designed more effectively,' Germany's Chancellor Merkel said at a press conference after the meeting⁴⁰².

Only two of the ESM's six available aid tools have been used so far: long-term loans for Greece, Ireland, Cyprus, and Portugal and indirect aid to help Spain recapitalise its banking sector. Euro area leaders used their December summit to reach agreement on how they want that toolbox to look in the future.

The precautionary tools – which are similar to instruments that the IMF has – were at the centre of a vigorous debate about how they should be used and what changes might be needed. Although they have not been used yet, they may some day be needed and the euro area has embarked on a plan to bolster their capabilities. The goal is to help the euro area stave off a crisis before it becomes entrenched, allowing the euro zone to bounce back more quickly and avoid the worst parts of the cycle.

Before the summit, Eurogroup finance ministers released 'term sheets,' or technical blueprints, for the ESM enhancement proposals. In the case of the precautionary tools, the aim was to make them more effective for countries that have well-managed economies but are nevertheless hit by an adverse shock beyond their control.

As a result, the euro area has pledged to clarify how it determines whether or not a country has pursued sound economic and financial policies, and it affirmed that countries will always need to show the sustainability of their general government debt.

'The eligibility process will be made more transparent and predictable,' the Eurogroup said. In its term sheet⁴⁰³ on ESM reforms, it said eligibility for such a credit line would be reviewed at least every six months, and if conditions worsened then the country needing support might have to move to an enhanced conditions credit line or a full macroeconomic adjustment programme.

⁴⁰² 'European Council - National briefing Germany - December 2018, Press conference,' Video, 14 December 2018. <https://ec.europa.eu/avservices/video/player.cfm?ref=I165257>

⁴⁰³ Term sheet on the European Stability Mechanism reform, 4 December 2018. https://www.consilium.europa.eu/media/37267/esm-term-sheet-041218_final_clean.pdf

Coupled with the bank backstop, the strategy when implemented promises to offer an additional level of protection and cooperation.

The euro area's plan for the ESM also calls for changes to other rescue offerings. When the ESM takes over the bank backstop, that mission will replace direct bank recapitalisation in the firewall's toolkit. The ESM will provide a credit line for the Single Resolution Fund when needed, to make sure the resolution fund has enough cash to handle the meltdown of a large financial firm. Any non-euro countries that join the banking union would be expected to provide their own revolving credit lines alongside the euro area bank backstop⁴⁰⁴.

Should the resolution fund or its backstop ever be used, outlays would be paid back by raising levies on European banks. If called upon, the ESM could make the difference in helping the system work as designed. The new system will be up and running no later than 2024, or earlier, depending on how other elements of the strategy progress.

'With the highest paid-in capital of all international financial institutions and substantial firepower, the ESM can also provide a credible backstop to banking union,' Centeno said already in a message in the 2017 ESM annual report⁴⁰⁵.

In their summit statement⁴⁰⁶, euro area leaders asked their finance ministers to prepare the necessary ESM Treaty amendments by June 2019. They said the ESM enhancements would be a core element of an effort to 'significantly strengthen' monetary union. Their comprehensive package also directed the Eurogroup to design a euro area budget instrument for competitiveness and convergence that could be incorporated into the EU's multi-year fiscal framework, and it endorsed Commission efforts to strengthen the role of the euro in the international financial system.

Taken together, all these developments will strengthen the euro area and its firewall, and set the stage for future considerations. 'This is part of a wider debate about fiscal risk sharing,' Regling said during a July 2018

⁴⁰⁴ Terms of reference of the common backstop to the Single Resolution Fund, 4 December 2018. https://www.consilium.europa.eu/media/37268/tor-backstop_041218_final_clean.pdf

⁴⁰⁵ ESM (2018), *ESM annual report 2017*, p. 12, Publications Office, Luxembourg, 21 June 2018. <https://www.esm.europa.eu/publications/esm-annual-report-2017>

⁴⁰⁶ Statement of the euro summit of 14 December 2018, Press release 790/18, 14 December 2018. <https://www.consilium.europa.eu/en/press/press-releases/2018/12/14/statement-of-the-euro-summit-14-december-2018/pdf>



ESM management board
and heads of division

Credit: Steve Eastwood/ESM

workshop at the ECB⁴⁰⁷. While controversial, there is also talk about common area fiscal tools such as a rainy-day fund or a joint fund for investments. These are all linked to discussions about a possible future sovereign debt restructuring framework, which would make settlements with private creditors more transparent and more predictable. The ESM could play a constructive role by providing debt sustainability analyses and by facilitating talks between creditors and debtors. ‘In my view, we don’t need to have a more rigid approach but a more transparent one,’ he said. ‘And the ESM can play a role in such a framework.’

The December 2018 decisions will allow the euro area to make the most of the strength it built during the crisis years. Even so, there remains room for the ESM, and the euro area’s overall architecture, to develop further. To prepare, the euro area has embarked on an ambitious period of reflection and change. The monetary union’s recent achievements are significant, but the euro area’s defence system is still not as solid as it could be. Those who lived through the crisis negotiations know the euro area would be better served if the remaining deficiencies were fixed now, rather than when the next crisis hits. This includes building public support for euro area reforms, as well as designing better rules and sturdier safeguards.

‘Our Economic and Monetary Union remains incomplete. There is a need to consolidate and complement the unprecedented measures we took during the crisis and make them more socially and democratically legitimate,’ said European Commission President Juncker.

⁴⁰⁷ ESM (2018), ‘The role of the ESM in a deeper monetary union – speech by Klaus Regling’, Speech, 4 July 2018. <https://www.esm.europa.eu/speeches-and-presentations/role-esm-deeper-monetary-union-speech-klaus-regling>

The ESM has plenty to do in the meantime. The firewall must continue to manage the financing and repayment of the rescue programmes that took place, and it must consider how best to rebalance its workforce as it takes stock of its expanded mandate. The ESM also will continue to develop its investment and funding side, and to adjust its workforce to best handle the fund's ongoing duties.

'We have to prepare for a steady-state period where there is less excitement, more routine work,' Regling said.

From the outset, the ESM has been mindful of attracting a diverse range of investors and it is constantly looking for ways to tap new funding sources. It has added private placements and non-euro issuance to the regular presence with liquid euro benchmarks. These are needed not only to keep up with their current liquidity needs, but also so that the ESM can offer a new programme at a moment's notice. 'We are a crisis mechanism,' said Ruhl, ESM head of funding and investor relations. 'We have to be ready and able to act in difficult market situations to raise additional money.'

The investment team aims to expand its capacity by making use of additional financial instruments, such as non-euro assets and short money market futures. The team also continuously aims to refine its asset allocation and benchmarking to improve the quality of its asset management. In parallel, it participates in discussions with shareholders to explore potential framework revisions, to increase the ESM's long-term investment performance. Finally, the team is adjusting to ongoing changes: the reduced liquidity of the European bond market requires improved monitoring of market conditions; the development of responsible investment may lead to the introduction of new investment principles, and; regulatory changes, such as the revision of Libor rates, lead to the adaptation of existing instruments and contracts.

'Our responsibility to our shareholders is to make the most of the funds we manage, within a tight framework,' said Frankel, ESM deputy managing director and CFO. 'We don't want to shut ourselves off from opportunities by not having the right product mix.'

Given its crisis experience, the ESM is now better placed than ever to monitor all of the countries that received financing support during the crisis, to make sure they can repay their loans as agreed, and to assist in the euro area's efforts to protect the monetary union from future shocks. This reflects the institution's growth since its inception on the way to its current maturity.



Managing Director Klaus Regling and the ESM staff at the fund's fifth anniversary. The team is ready to take on new mandates following the December 2018 euro summit.

Credit: Steve Eastwood/ESM

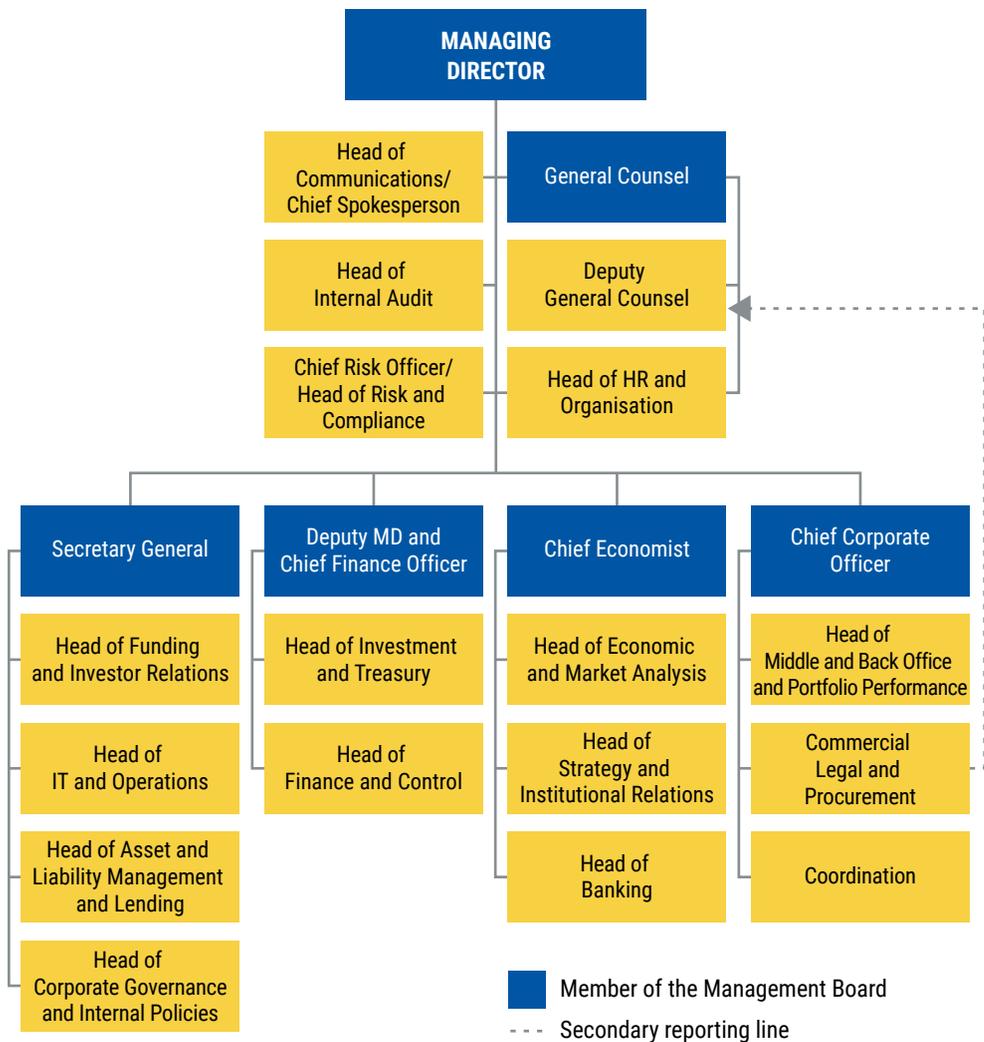
‘It has earned its credibility,’ said Malta’s Camilleri. ‘The ESM is an institution which is alive and kicking, quite dynamic, and it is growing over time. Initially its participation in certain negotiations was substantially less than it is now. Its presence is much more visible now.’

The rescue fund fits in a broader framework of strengthening growth, increasing resiliency and protecting against future shocks, said Dijsselbloem, former chairman of the ESM Board of Governors and former Dutch finance minister. ‘All that would make it less likely that ESM programmes are needed again anytime soon,’ he said. ‘However, as crises do happen in our economic system, it is good to know that the ESM is the euro area’s stability anchor – an anchor the euro area will always be able to rely on.’

One day, the ESM may be fully integrated in the EU framework, through an amendment of the EU treaties. Like the EIB, the ESM could have its own protocol within the EU Treaty, while also keeping its capital and key features of its governance structure. In the meantime, the firewall will continue to strengthen and improve, in order to fulfil all of the missions its Members have envisaged.

‘The ESM’s place is in the EU treaties and I’m sure that one day it will be,’ said Regling. ‘Although we are intergovernmental for the time being, at our core, we are an EU institution. Created by a great showing of European solidarity, we are one of the Union’s key defences and will remain so for the future.’

ESM organisational chart (2018)



The ESM by 2018 had grown into a mature organisation, establishing a management structure that was both practical and well suited to its operational needs.

Source: ESM

Epilogue

This is exactly what we wanted to achieve: calm the markets and make sure that our support is no longer needed. Although we have indeed helped to do so, we cannot afford to relax.

Klaus Regling

ESM Managing Director and EFSF Chief Executive Officer

The ESM produced this book as part of its mission to protect the euro. It is intended both to commemorate the currency union's endurance, and to ensure that the lessons of recent history are not forgotten.

Drawing on the experience of the EFSF, the permanent rescue fund was created by Europe's policymakers in response to the greatest economic shock not only in the life of the euro, but also in the entire post-World War II era of European integration. It was, to be sure, an economic and financial crisis, but also a crisis of the imagination: the euro was set up in 1999 without a rescue fund. The risk that a country that uses the euro could plummet towards default was seen as negligible, or not seen at all.

It thus took time, even in the interdependent euro area economy of the 21st century, for the continent-wide consequences of financial

woes in individual countries to sink in. The crisis-response strategy that emerged, gradually, was in keeping with Robert Schuman's dictum in 1950 that the institutions and governance of a more united Europe would not 'be made all at once, or according to a single plan.'

In that sense, the rescue fund that exists today was the product of three evolving 'plans,' from the bilateral arrangements of the Greek Loan Facility in April 2010, to the EFSF later that summer, and on to the fully fledged ESM in October 2012. For many, especially in countries seeking relief, progress seemed painfully slow. But on the broader timescale of European integration, the record is more impressive. After all, it took a half century, punctuated by a false start in the early 1970s, for European nations to move from the first notions of monetary union to a single currency.

'Who would have thought, only 10 years ago, that Europe would have put in place a European Stability Mechanism?' said IMF Fiscal Affairs Director Vítor Gaspar, who served as Portuguese finance minister during the crisis. 'The progress was quite remarkable. The results were not instantaneous but they could not have been expected to be so.'

Together with fiscal and structural reforms at the European and national level, the ECB's unconventional monetary policy and the creation of a banking union, the rescue funds saw off the worst of the crisis and made monetary union more resilient.

'Three things saved the euro zone,' Greek central banker Yannis Stournaras said. 'The first was the creation of the EFSF, and later the ESM. The second was [ECB President] Mario Draghi's decision to do 'whatever it takes.' The third, of course, was the governments of the programme countries which took very, very difficult decisions.'

Underlying these three courses of action was a shared approach to economic policy, and a recognition that Europe is better off with a single currency than without one. Rescue fund lending, ECB intervention, and programme country reforms were mutually supportive, and each cannot be conceived of without the others.

The EFSF and ESM were dedicated to safeguarding the stability of the euro area as a whole, by providing financial assistance in return for economic, structural, budgetary and financial sector reforms. Over the course of the crisis, the EFSF's total financial assistance package reached €185.6 billion, alongside €109.6 billion from the ESM.

As bonds sold to finance this aid come to maturity, the rescue funds will issue new bonds as necessary until all the programme countries have paid back their obligations. In carrying out this day-to-day business of refinancing the loans, the rescue funds are operating in a financial market environment that has been transformed by decisions taken during the crisis. From the EFSF's first bond sale, the rescue funds have enjoyed a reputation as top-rated borrowers, in turn underpinning sovereign borrowers across post-crisis Europe. The ESM, backed by its Members' capital and now with an established track record, is at the centre of the architecture sustaining the euro area's strength.

While it would be best if the ESM's aid is never again needed on such an extensive scale, the euro area must maintain the capacity to act when required. 'It's better to be safe than sorry. It's an essential element of the euro zone economic governance framework,' said Rehn, Finnish central bank governor since July 2018, who was European commissioner for economic and monetary affairs and the euro during the crisis.

During 2017 and 2018, the euro area enjoyed strong economic growth. Budget deficits narrowed significantly, and debt fell overall. Growth is benefiting countries across the board, with some of the former programme countries in particular displaying the strongest economic performance thanks to the reforms they undertook. Four of the five countries helped by the EFSF and ESM are economic successes. The fifth programme country, Greece, has also made great strides. It successfully exited its third programme on 20 August 2018 and now needs to continue with its reform agenda to strengthen its growth potential.

The crisis proved the mettle of the ESM as an institution, anchoring it in the euro area landscape. But there was a personal side to this as well. It is impossible to write of the ESM's contribution to the European project without acknowledging the commitment of its employees, who bring a wide range of professional expertise to the common goal of defending the single currency.

Especially at the start, the hours were long and it was hard to tell whether going to work for a special purpose vehicle in Luxembourg was the right career move. But in the words of Chief Economist Rolf Strauch, echoing the view inside the ESM, the effort was worth it. 'Personally for me, there is absolutely zero regret. This is probably

a once in a lifetime unbelievable roller coaster type of experience,' Strauch said.

When Schuman proposed pooling French and German coal and steel production as a first step towards European economic unity all those years ago, one of his initial goals was 'the aim of contributing to raising living standards and to promoting peaceful achievements'⁴⁰⁸.

This effort resounds down through the history of what is now the EU, with the ESM standing as the latest example of the practical problem-solving that paves the way for a more prosperous future. As the ESM prepares to take up a new set of challenges envisaged by European leaders, it will strive to do what is right for the citizens of the euro area.

A more robust monetary union contributes to the betterment of all. As ESM Managing Director Regling says: 'All euro area countries and their citizens benefit.'

⁴⁰⁸ Schuman, R. (1950), 'The Schuman Declaration', 9 May 1950.
https://europa.eu/european-union/about-eu/symbols/europe-day/schuman-declaration_en

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Biographies

Maria Luís Albuquerque

Ms Albuquerque is a member of the Portuguese Parliament and a non-executive director at UK-based Arrow Global. She was Portugal's Minister of State and Finance between 2013 and 2015, when she oversaw the final implementation and successful exit in May 2014 of Portugal from its financial assistance programme. During this time, Portugal received support from the EFSF, the EU, and the IMF. Ms Albuquerque has been in government since 2011, initially as Deputy Minister of the Treasury. Before that, she was Head of Issuing and Markets at the Portuguese Debt Management Agency.

Kalin Anev Janse

Mr Anev Janse is Secretary General of the ESM and EFSF and the Management Board member responsible for Funding and Investor Relations, IT and Operations, Asset Liability Management and Lending, and Corporate Governance and Internal Policies. He previously worked for the European Investment Bank, where one of his tasks was to coordinate setting up the EFSF. Prior to this, he was a corporate finance advisor for McKinsey & Company.

Benjamin Angel

Mr Angel is Director for Treasury and Financial Operations at the European Commission. During the financial crisis, he was Head of Unit in charge notably of the creation of the European sovereign firewalls, the EFSF, the ESM, and the EFSM, and the macro-prudential supervision body, the European Systemic Risk Board. He has worked at the European Commission since 1994.

Françoise Blondeel

Ms Blondeel is the ESM's Chief Corporate Officer and the Management Board member responsible for the Middle Back Office and Portfolio performance, Strategy and Planning, Procurement, and promoting diversity within the ESM. Before joining the EFSF in 2012, Ms Blondeel worked as Head of Middle and Back Office at the French debt management office and at CADES, the French agency responsible for redeeming social security debt.

Marco Buti

Mr Buti has been the Director-General for Economic and Financial Affairs at the European Commission since 2008, during which time all six EFSF and ESM financial assistance programmes were agreed upon. He began his career at the European Commission in 1987 and served in a variety of senior roles.

Alfred Camilleri

Mr Camilleri has been Permanent Secretary at the Maltese Ministry for Finance since 2006. He has served as Chairman of the Compensation Committee of the ESM since 2014. In a public service career spanning 40 years, he has served as Director at the Central Office of Statistics, and Director General at the National Statistics Office. He is also a visiting lecturer in statistics and public policy at the University of Malta.

Kevin Cardiff

Mr Cardiff is the non-executive director of KBC Bank Ireland, a member of the European Court of Auditors, and the current Chairperson of the external Board of Auditors of the ESM. He served as Secretary General in Ireland's Department of Finance from 2010 to 2012. He helped to oversee Ireland's application for financial assistance in November 2010 and the programme's initial implementation. The programme was the EFSF's first.

Mário Centeno

Mr Centeno has been the Chairperson of the ESM Board of Governors and the President of the Eurogroup since January 2018. He has also served as the Portuguese Minister of Finance since 2015, after being elected as a Member of the Parliament in the same year. Previously, he was an economist at the central bank of Portugal and a university professor.

Luis de Guindos

Mr de Guindos is the vice president of the ECB. From 2011 to 2018, he served as Spain's Minister of Economy, Industry and Competitiveness. He negotiated the ESM's banking sector programme, overseeing its implementation and successful conclusion in December 2013. In addition to previous senior posts in the Spanish government, he has private sector experience with PricewaterhouseCoopers and Lehman Brothers.

Jeroen Dijsselbloem

Mr Dijsselbloem served as President of the Eurogroup from February 2013 to January 2018 and, simultaneously, as Chairman of the ESM Board of Governors. He was also the Dutch Minister of Finance from 2012 to 2017. From 2000 to 2012, he was a member of the Dutch House of Representatives.

Mario Draghi

Mr Draghi has been President of the European Central Bank since 2011. Previously, he was Governor at the Bank of Italy from 2006 to 2011, while also serving as the Chairman of the Financial Stability Forum (later the Financial Stability Board). He was Director of the Italian Treasury from 1991 to 2001.

David Eatough

Mr Eatough is the General Counsel of the ESM and the EFSF and the Management Board member responsible for the legal affairs of both institutions, and for Human Resources and Organisation. He joined the ESM in 2013, having worked for more than 20 years in several major financial centres around the world, both in investment banking and as a partner at a leading international law firm. He is qualified as a solicitor in Ireland and as a solicitor and barrister in England and Wales.

Christophe Frankel

Mr Frankel has been the Deputy Managing Director and CFO of the ESM since its foundation and CFO and Deputy CEO of the EFSF since its 2010 creation. He is the Management Board member responsible for Investment and Treasury, and Finance and Control. Previously, he was Head of Financial Markets at Crédit Foncier de France in Paris and beforehand CFO for CADES, the French agency responsible for redeeming social security debt.

Mitsuhiro Furusawa

Mr Furusawa has been Deputy Managing Director at the IMF since 2015. He was also IMF Executive Director from 2010 to 2012. Other key positions include: Vice Minister of Finance for International Affairs at the Japanese Ministry of Finance from 2013 to 2014 and Special Advisor to Japanese Prime Minister Shinzo Abe.

Vítor Gaspar

Mr Gaspar is Director of the Fiscal Affairs Department of the International Monetary Fund. He was Portugal's Minister of State and Finance from 2011 to 2013. In this role, he oversaw the initial implementation of the Portuguese assistance programme, which was agreed just before he assumed office. He previously served in senior policy positions at the Portuguese central bank and headed the European Commission's Bureau of European Policy Advisers from 2007 to 2010.

Timothy Geithner

Mr Geithner is President of the private equity firm Warburg Pincus. He was US Secretary of the Treasury from 2009 to 2013, helping to successfully guide the US through the financial crisis. Previously, he served as President of the Federal Reserve Bank of New York for five years, after a career at the US Treasury and the IMF.

Vittorio Grilli

Mr Grilli is Chairman of the Europe, Middle East and Africa operation of J.P. Morgan's Corporate & Investment Bank. He was the Italian Minister of Economy and Finances from 2012 to 2013. He previously served in multiple roles with the Italian Treasury and on the EU's Economic and Financial Committee from 2009 to 2012, of which he ultimately became Chairman.

Georges Heinrich

Mr Heinrich is the Secretary General at the Banque de Luxembourg. He was the EFSF's first sole director, and was Chairman of the EFSF Board of Directors from 2012 to 2014. He also served as Treasurer-General at the Ministry of Finance of Luxembourg.

Deborah Henderson

Ms Henderson owns and runs Centre for Inspired Leadership, which specialises in workplace culture and leadership for organisations in the financial sector. In late 2011, Ms Henderson was hired as a coach to the Management Team of the EFSF. A culture initiative she helped design was rolled out in phases throughout 2012 and 2013.

Ralf Jansen

Mr Jansen was the first General Counsel of the ESM and the EFSF and a member of the Management Board for more than six years until 2016. Previously, he worked for HSBC and a Bank of New York Mellon asset management affiliate. He has since left the ESM to set up in private practice.

Jean-Claude Juncker

Mr Juncker has been European Commission President since 2014. From 2004 to 2013, he served as the first President of the Eurogroup, and therefore as the first Chairman of the ESM Board of Governors. During his tenure as Eurogroup President, the EFSF programmes for Ireland, Greece (II), and Portugal, as well as the ESM programmes for Spain and Cyprus were agreed upon. In the 18 years prior to his appointment as European Commission President. He was Luxembourg's Prime Minister, during much of which he also served as Luxembourg's Finance Minister.

Peter Kažimír

Mr Kažimír has been Finance Minister of Slovakia since 2012. In addition, from 2012 to 2016, and again from 2018, he has also served as Deputy Prime Minister. From 2010 to 2012, he was a Member of Parliament and Vice-Chairman of the Finance and Budget Committee. Since 2010 he has also been the Vice-Chairman of Social Democracy (SMER-SD). From 2006 to 2010, he served as State Secretary of the Finance Ministry.

Christine Lagarde

Mme Lagarde has been the Managing Director of the IMF since 2011. She was French Finance Minister from 2007 to 2011, when the EFSF was created, and also served as Minister of State for Foreign Trade for two years. She entered politics after a career as an anti-trust and labour lawyer at Baker McKenzie, an international law firm, where she was global chairman.

John Lipsky

Mr Lipsky is the Peter G. Peterson Distinguished Scholar at the Henry A. Kissinger Center for Global Affairs and a Senior Fellow at the Foreign Policy Institute, both of the Paul H. Nitze School for Advanced International Studies at Johns Hopkins University. Mr. Lipsky was First Deputy Managing Director of the IMF from 2006 to 2011 and Acting Managing Director from May to July 2011. He worked for the IMF early in his career before joining the private sector. Prior to rejoining the IMF, he was Vice Chairman of J.P. Morgan Investment Bank and J.P. Morgan's Chief Economist.

David Lipton

Mr Lipton has been the IMF's First Deputy Managing Director since 2011. Previously, he was Special Assistant to US President Barack Obama, Senior Director for International Economic Affairs at the National Economic Council and National Security Council at the White House. Under President Bill Clinton, he served as Under Secretary for International Affairs at the US Treasury, and before that as Assistant Secretary.

George Papaconstantinou

Mr Papaconstantinou is a Professor at the European University Institute and works in an advisory capacity in the private sector. He served as Greek Finance Minister from 2009 to 2011. In May 2010, during his tenure as Greek Finance Minister, euro area member states and the IMF granted Greece its first financial assistance programme. He is also a former Minister for the Environment, Energy and Climate Change.

Klaus Regling

Mr Regling is the first Managing Director of the ESM. He is also the CEO of the EFSE, a position he has held since its creation in June 2010. An economist, he worked at the IMF for a decade and at the German Ministry of Finance for another decade, where he helped prepare for European Economic and Monetary Union. From 2001 to 2008, he was Director General for Economic and Financial Affairs at the European Commission.

Olli Rehn

Mr Rehn is Governor of the Bank of Finland. He was the European Commissioner for Economic and Monetary Affairs and the Euro during much of the financial crisis from 2010 to 2014. Earlier, he was Commissioner for Enlargement and Commissioner for Enterprise and the Information Society. He served as Finland's Minister for Economic Affairs from 2015 to 2016, and was a Member of Parliament and a Member of the European Parliament in the 1990s and 2010s.

Michael Sarris

Mr Sarris was the Finance Minister of Cyprus on two separate occasions. During his first term, from 2005 to 2008, he helped to prepare Cyprus for the adoption of the euro. In his second term, he negotiated Cyprus's financial assistance package from the ESM and IMF in 2013. He previously worked at the Central Bank of Cyprus and for the World Bank.

Wolfgang Schäuble

Mr Schäuble is the President of the German Parliament. He was Germany's Finance Minister from 2009 to 2017, when both the EFSF and the ESM were created and all six of their financial assistance programmes were agreed upon. Previously, he was Minister of the Interior from 1989 to 1991 and again from 2005 to 2009. He has been a member of the Bundestag since 1972.

Yannis Stournaras

Mr Stournaras has been the Governor of the Bank of Greece since 2014. He was the Greek Finance Minister between 2012 and 2014, overseeing the implementation of Greece's second financial assistance package with the EFSF. He worked as special advisor to the Ministry of Finance and the Bank of Greece through much of the 1980s and 1990s and helped negotiate Greece's ascension to the euro as a member of the Monetary Committee of the European Union. He was previously an academic at Oxford and the University of Athens.

Rolf Strauch

Mr Strauch is Chief Economist and Management Board Member of both the EFSF and ESM, in charge of Economics, Policy Strategy, and Banking. Before joining the EFSF in 2010, he worked at the European Central Bank and at the Deutsche Bundesbank.

Fernando Teixeira dos Santos

Mr Teixeira dos Santos is an economics professor at the University of Porto and a Director of Banco BIC Português. He was Portugal's Minister of Finance from 2005 to 2011, when the EFSF was created. He requested Portugal's loan from the EFSF, but left office soon after. He was Chairman of the Portuguese Securities and Exchange Commission from 2000 to 2005 and, from 1995 to 1999, he was Secretary of State for the Treasury and Finance.

Jean-Claude Trichet

Mr Trichet is Chairman of the Brussels-based Bruegel economic think tank and of the Trilateral Commission for Europe. Previously, Mr Trichet was the second President of the European Central Bank, serving from 2003 until 2011, having held the post of Governor of the Bank of France for the previous 10 years. He was President of the Global Economy Meeting at the Bank for International Settlements, and the first President of the European Systemic Risk Board.

Euclid Tsakalotos

Mr Tsakalotos has been the Greek Minister of Finance since 2015. During his tenure, Greece implemented its third financial support programme, with the ESM, which concluded successfully in August 2018. He is a member of the Central Committee of the Syriza party and has been a Member of Parliament since 2012. He is also a professor of economics at the University of Athens.

David Vegara

Mr Vegara is a lecturer at ESADE Business School and a member of the Board of Banco Sabadell. He served as ESM senior advisor and Deputy Managing Director for Banking from September 2012 through February 2015. Previously, he worked at the IMF as Deputy Director of the Western Hemisphere Department. Before joining the IMF, from 2004 to 2009, he was State Secretary for Economic Affairs at the Spanish Ministry of Economy and Finance, serving also as chairman of the European Union's Financial Services Committee from 2005 to 2009.

Maarten Verwey

Mr Verwey has served as Director-General of the European Commission's Structural Reform Support Service since 2015. In 2010, while working at the Dutch Ministry of Finance, he was appointed Chairman of the Task Force on Coordinated Action, which was responsible for the coordinated European response to the financial crisis, serving through 2015. During this time, he played a key role in the EFSF's creation and structure. He began his career at the Dutch Ministry of Finance in 1994.

Thomas Weinberg

Mr Weinberg is the Division Head of Trading and Issuing Business at the German Finance Agency. In 2010, he was appointed project manager in charge of establishing the infrastructure for the funding operations of the EFSF, in terms of both staffing and strategy. He and his team set up the EFSF's initial issuance programme and ran the EFSF's first and many subsequent issues.

Thomas Wieser

Mr Wieser was Chairman of the European Union's Economic and Financial Committee from 2009 to 2011 and from 2012 to 2018, and President of the Eurogroup Working Group from 2011 to 2018. At their helm, he played a key role in putting together and achieving consensus among the euro area member state representatives on the financial assistance programmes run by the EFSF and the ESM.

Timeline

1979	13 March	European Monetary System enters into force. This includes the European Exchange Rate Mechanism, designed to reduce currency fluctuations in preparation for Economic and Monetary Union (EMU).
1989	9 November	Berlin Wall falls .
1990	1 July	The first stage of EMU starts with capital movement restrictions lifted and cooperation between central banks enhanced.
1992	7 February	Maastricht Treaty is signed, amending the European treaties to achieve EMU and establishing the EU.
1994	1 January	Second stage of EMU starts with establishment of the European Monetary Institute.
1998	1 June	ECB is established .
1999	1 January	Third and final stage of EMU starts . Monetary union begins with the introduction of cashless euro transactions in first 11 countries – Belgium, Germany, Ireland, Spain, France, Italy, Luxembourg, the Netherlands, Austria, Portugal, and Finland – and the entry into force of the stability and growth pact.
2001	1 January	Greece adopts the euro, bringing membership to 12.
2002	1 January	Euro becomes legal currency, with notes and coins reaching people's pockets for the first time.
2004	1 May	Eight mainly central and eastern European countries join the EU, bringing membership to 25.
2007	1 January	<ul style="list-style-type: none"> Slovenia adopts the euro, bringing membership to 13. Bulgaria and Romania join the EU, bringing membership to 27.
	17 July	US investment bank Bear Stearns informs investors that two hedge funds that invested in subprime-backed securities have very little value remaining, and on 31 July files for bankruptcy and liquidates them.

2008

9 August	BNP Paribas, France's largest bank, halts redemptions on three investment funds because of subprime concerns.
14 September	UK Treasury authorises the Bank of England to provide liquidity support for Northern Rock, the country's fifth-largest mortgage lender.
1 January	Malta and Cyprus adopt the euro, bringing membership to 15.
17 February	UK nationalises Northern Rock.
24 March	US Federal Reserve agrees to guarantee \$30 billion of Bear Stearns assets as part of a government-sponsored sale to JPMorgan Chase.
7 September	US government takes over mortgage giants Freddie Mac and Fannie Mae.
15 September	<ul style="list-style-type: none"> Lehman Brothers files for biggest bankruptcy in US history. Bank of America agrees to buy Merrill Lynch for \$50 billion, rescuing the investment bank.
16 September	US Federal Reserve authorises loan of \$85 billion to the American International Group (AIG), the world's largest insurer.
18 September	Lloyds TSB announces it is taking over the UK's biggest mortgage lender, HBOS, in a £12 billion deal.
25 September	Ireland's Central Statistics Office announces the country is officially in recession.
28 September	European banking giant Fortis is partly nationalised .
29 September	US Congress rejects Wall Street financial rescue package, including the \$700 billion Troubled Asset Relief Program (TARP).
30 September	<ul style="list-style-type: none"> Irish government issues guarantee for banks' liabilities. Dexia Bank receives €6.4 billion in financial assistance from governments of Belgium, France, and Luxembourg.
3 October	US Congress passes a revised version of the financial package that includes TARP, which President George W Bush signs into law.
4 October	Leaders of Germany, France, Italy, and the UK call for international summit to address the crisis.

8 October	<ul style="list-style-type: none"> • UK government announces £500 billion bank bailout scheme. • Six central banks (Bank of Canada, Bank of England, ECB, US Federal Reserve, Sveriges Riksbank, Swiss National Bank) lower rates in coordinated move.
10 October	Group of Seven finance ministers and central bank governors call for 'urgent and exceptional action' to 'stabilize financial markets and restore the flow of credit, to support global economic growth'.
13 October	UK government announces £37 billion rescue plan for Royal Bank of Scotland, HBOS, and Lloyds TSB.
31 October	Financial assistance of €20 billion agreed for Hungary . Of the total, the EU contributes €6.5 billion; the IMF €12.5 billion; and the World Bank €1 billion.
15 November	Group of 20 (G20) summit in Washington DC. Leaders meet to coordinate their response to the financial crisis. They agree to 'take whatever further actions are necessary to stabilize the financial system', including increased oversight of banks and the reform of global financial institutions.
3 December	US Securities and Exchange Commission strengthens oversight of credit-rating agencies, which it says 'contributed to the recent turmoil in the credit markets' through their ratings of subprime-backed securities.
19 December	US President Bush offers up to \$17.4 billion in emergency loans for car makers General Motors and Chrysler.
21 December	Irish Finance Minister Brian Lenihan announces plan to recapitalise the country's three main banks: Anglo Irish Bank, Allied Irish Bank, and Bank of Ireland.
1 January	Slovakia adopts the euro, bringing membership to 16.
14 January	Standard & Poor's downgrades Greece: A- from A, the first in a series of downgrades leading to the eventual loss of investment grade.
15 January	Irish government announces nationalisation of Anglo Irish Bank after determining recapitalisation is insufficient.
19 January	Standard & Poor's downgrades Spain: AA+ from AAA, the first in a series by the major ratings agencies, although the country never loses investment grade.
20 January	Ecofin approves €3.1 billion financial assistance to Latvia, part of a total €7.5 billion package. Of that total, the IMF commits €1.7 billion; the World Bank, the European Bank for Reconstruction and Development (EBRD), and seven individual European countries also pledge assistance.

2009

21 January	Standard & Poor's downgrades Portugal: A+ from AA-, the first in a series of downgrades leading to the eventual loss of investment grade.
23 January	The 'Vienna Initiative' to safeguard the financial stability of emerging Europe is launched .
11 February	Recapitalisation terms agreed for Allied Irish Bank and Bank of Ireland. Each is to receive €3.5 billion.
30 March	Standard & Poor's downgrades Ireland: AA+ from AAA, the first in a series of downgrades leading to the July 2011 loss of its investment grade.
2 April	G20 summit in London. Leaders agree to expand the Financial Stability Forum into the Financial Stability Board with a beefed-up role monitoring the global financial system.
4 May	IMF approves €12.9 billion stand-by arrangement for Romania, part of a total €20 billion package . Of that total, the EU commits €5 billion; the World Bank €1 billion; the EBRD and the EIB a combined €1 billion.
26 June	Spanish government establishes FROB to channel public financial support to banks.
25 September	G20 summit in Pittsburgh. Leaders decide that it is the appropriate international forum to deal with the current crisis and draws up the 'Framework for strong, sustainable and balanced growth'.
21 October	Greece announces that the government deficit is much worse than previously reported. The 2008 deficit was 7.7%, not 5%, and in 2009 the deficit was planned to be 12.5%, not 3.7%.
13 November	Eurostat says that euro area GDP increased by 0.4% in the third quarter of 2009, the first increase after five consecutive quarters of economic contraction.
22 November	Ireland's National Asset Management Agency Act 2009 becomes law, creating a 'bad bank' that becomes operational in December.
2010	
2 February	Greece adopts measures to cut the fiscal deficit, including wage freezes.
11 February	EU leaders declare that they 'will take determined and coordinated action, if needed, to safeguard financial stability in the euro area as a whole.'
5 March	Greek parliament passes a package of measures that freeze pensions, cut civil servant salaries, and raise taxes.

25 March	EU leaders meet and pledge to offer support to Greece alongside IMF, noting country has not yet asked for assistance.
30 March	Ireland's National Asset Management Agency buys a first batch of loans at an average discount of 47%.
31 March	Anglo Irish reports biggest corporate loss in Irish history, €12.7 billion for the 15 months to end-2009 after writing off €15.1 billion in bad loans.
22 April	Eurostat revises the Greek 2009 deficit up to 13.6% with a final upward revision to 15.4% on 15 November.
23 April	Greece formally requests financial assistance from the euro area member states and the IMF.
2 May	Eurogroup approves a three-year, €80 billion, bilateral loan programme for Greece (GLF), part of a €110 billion package. Of that total, IMF commits €30 billion in a stand-by arrangement on 9 May.
9 May	Agreement is reached on setting up the EFSF. It will have a total lending capacity of €440 billion.
10 May	ECB launches its Securities Markets Programme to address 'severe tensions in financial markets'.
7 June	EFSF is established in Luxembourg.
27 June	G20 summit in Toronto. Amid protests, leaders meet to discuss the global economic crisis, concluding 'serious challenges remain'.
4 August	EFSF becomes fully operational.
7 September	Ecofin endorses reforms agreed with the European Parliament on the EU framework for supervising the financial system, including the setting up of a macroprudential oversight body under the auspices of the ECB, the European Systemic Risk Board, as well as three supervisory authorities for banks, securities markets, and insurance companies.
12 September	Basel Committee on Banking Supervision adopts the Basel III accord, introducing higher global minimum capital standards for banks.
29 September	European Commission proposes six legislative measures to improve the EU's fiscal and economic governance and surveillance (the 'six-pack'). These include strengthening the stability and growth pact and introducing a process to monitor and correct macroeconomic imbalances.

30 September	Irish Finance Minister Lenihan says the cost of supporting the banking sector (€46 billion at end 2010) will cause a 'substantial spike' in the country's deficit.
18 October	German Chancellor Angela Merkel and French President Nicolas Sarkozy meet in Deauville, and agree to ensure that bondholders, such as banks and hedge funds, share some of the costs of risky lending by participating in the rescue of euro area member states on the brink of insolvency.
21 October	European Council task force report includes recommendations to improve budgetary discipline and establish a permanent crisis management mechanism.
29 October	European Council agrees to establish a new permanent crisis resolution mechanism, the ESM, in 2013.
3 November	Hungary's international financial assistance programme expires .
12 November	G20 summit in Seoul. Leaders discuss strengthening the international financial regulatory system and financial safety nets, as well as pursuing the reform of international financial institutions.
16 November	Standard & Poor's downgrades Cyprus: A from A+, the first in a series of downgrades by the three major rating agencies leading to the 2012 loss of investment grade.
21 November	<ul style="list-style-type: none"> • Ireland requests financial assistance from the EU, euro area member states, and the IMF. • Eurogroup and Ecofin agree to provide Ireland with assistance through what will become the EFSF's first programme.
7 December	The Council of the European Union formally agrees Europe's share of an €85 billion joint financial assistance package for Ireland, with contributions from the EU, the euro area, and the IMF, bilateral contributions from Denmark, Sweden, and the UK, as well as Ireland's own contributions. The IMF approves its €22.5 billion extended arrangement for Ireland on 16 December.
16 December	ECB nearly doubles its capital to give it more leeway to take action in the crisis.
17 December	EU leaders adopt the treaty amendment required to set up the ESM (Article 136 of the Treaty on the Functioning of the European Union) and agree on its general format.
23 December	Ireland effectively nationalises Allied Irish Bank with capital injection of €3.7 billion.

2011

1 January	Estonia adopts the euro, bringing membership to 17.
25 January	EFSF places inaugural 5-year €5 billion bond. The issue is nearly nine times oversubscribed.
26 January	Following the EFSF's successful bond issue, Irish media question the high interest rate the rescue fund charges for loans to Ireland compared with its funding cost.
11 March	At special summit, euro area leaders boost the EFSF's lending capacity to the full €440 billion by agreeing on extra guarantees. They enable it to conduct primary market bond purchases and recommend that it reduce interest rates on programme country loans.
21 March	Eurogroup agrees to endow the ESM with €500 billion capacity, backed by €80 billion in paid-in capital and €620 billion in 'callable' capital.
23 March	Portuguese parliament rejects government's reform measures.
24 March	José Sócrates' government in Portugal resigns but remains in a caretaker capacity.
29 March	2010 Portuguese deficit reaches 8.6% of GDP, above the 7.3% target.
7 April	Portugal requests financial assistance from the EFSF, the EFSM, and the IMF.
12 May	Romania's second financial assistance programme takes shape ahead of the June 2011 end of the first programme. The second includes precautionary loans of up to €1.4 billion from the Council of the European Union, agreed on 12 May, and a €3.5 billion IMF stand-by arrangement, approved on 25 March 2011, also precautionary.
16 May	Eurogroup and Ecofin agree to provide financial aid to Portugal. Of the total €78 billion, the EFSF, EFSM, and the IMF each commits €26 billion.
5 June	Pedro Passos Coelho announces he will form a coalition following Portuguese elections that prompt Sócrates' resignation.
20 June	Eurogroup states that Greece is unlikely to regain private market access by early 2012.
24 June	EU leaders agree to take all steps required to ensure the ratification of the ESM Treaty by the end of 2012 and for rapid entry into force of the amended EFSF.

29 June	Greek parliament passes second fiscal consolidation bill after widespread protests and strikes.
July	Greek adjustment programme's fourth review says pace of reforms has substantially slowed, and recession is worse than projected.
11 July	Euro area member states sign the first ESM treaty.
21 July	Euro area leaders prepare for a second Greek programme, envisaging an EFSF contribution and private sector debt restructuring. Leaders also further expand the EFSF's toolkit.
16 August	German Chancellor Angela Merkel and French President Nicolas Sarkozy launch call for strengthened euro area governance.
2 October	Greece says it will miss key deficit targets agreed with its international lenders.
4 October	Ecofin approves the six-pack measures designed to strengthen economic governance in the EU.
13 October	EFSF Members approve an increase in guarantee commitments to €780 billion, including an overguarantee of up to 165%, to secure its €440 billion lending capacity.
26 October	Euro area leaders say the private sector has a 'vital' role to play in restoring Greek debt sustainability. They also agree two options to leverage the EFSF's resources.
31 October	Greek Prime Minister George Papandreou calls for a referendum on the rescue plan. It is cancelled three days later, and he resigns on 9 November.
1 November	Mario Draghi succeeds Jean-Claude Trichet as ECB president.
4 November	<ul style="list-style-type: none"> • G20 summit in Cannes. Leaders agree that supporting growth is a priority and decide to strengthen the IMF, increasing its lending capacity. • Financial Stability Board publishes an initial list of 29 'too-big-to-fail' systemic international banks.
11 November	Lucas Papademos is sworn in as new Greek prime minister.
20 November	Mariano Rajoy's centre-right People's Party wins an absolute majority in Spanish elections .
30 November	Global central banks (ECB, Bank of Canada, Bank of England, Bank of Japan, US Federal Reserve, and Swiss National Bank) announce coordinated plan to boost liquidity in global financial system.

2012

8 December	ECB cuts main interest rate to 1% and offers to lend to euro area banks under its longer-term refinancing operations for three years.
9 December	Euro area leaders agree to implement a 'fiscal compact' for stronger economic policy coordination and discipline, and reinforce rules for the excessive deficit procedure. They also decide to accelerate the entry into force of the ESM Treaty (with adjustments to make it more effective, such as an emergency voting procedure).
16 December	Cypriot parliament adopts measures to reduce the government deficit to 2.5% of GDP in 2012 from 6.3% of GDP in 2011.
23 December	Cyprus obtains a €2.5 billion loan from Russia. It restructures terms in 2013, and makes first repayment on schedule in March 2018.
5 January	EFSF implements diversified funding strategy, issuing first non-back-to-back bond, a 3-year maturity, raising €3 billion.
19 January	EU financial assistance programme to Latvia expires . This follows the conclusion of the IMF programme in December 2011.
31 January	Spanish jobless rate jumps to 22.9% in December 2011, or 5.27 million people – then the highest in the EU. The rate will peak at an average 26.2% in 2013, surpassed only by Greece's 27.5% during the crisis.
2 February	Euro area member states sign the second, amended, ESM Treaty .
17 February	EFSF launches the European Sovereign Bond Protection Facility and prepares to introduce the European Sovereign Bond Investment Facility, creating the two leverage vehicles agreed by euro area leaders in October 2011. Both are eventually dissolved, unused.
21 February	Eurogroup reaches preliminary deal on second assistance package for Greece.
28 February	As part of the Greek sovereign debt restructuring (bond exchange with private sector involvement (PSI)), ECB temporarily suspends the eligibility of marketable debt instruments issued or fully guaranteed by Greece for use as collateral in Eurosystem monetary policy operations. Eligibility is restored two weeks later.
1 March	European Commission says that major progress has been made in strengthening and downsizing Ireland's banking system, and that the recapitalisation of banks is largely complete.

9 March	Greek sovereign debt restructuring (bond exchange with private sector involvement) of around €199 billion begins , concluding on 25 April.
14 March	Euro area member states approve second Greek programme, with the EFSF. The overall €130 billion programme includes undisbursed funds from the IMF and EU from the first financial assistance programme. The next day, the IMF agrees a €28 billion extended fund facility for Greece, after Greece cancels its stand-by arrangement of 9 May 2011.
22 March	'The worst of the euro crisis is over,' ECB President Mario Draghi tells German newspaper <i>Bild</i> .
30 March	<ul style="list-style-type: none"> • Eurogroup decides to increase ESM/EFSF combined lending capacity to €700 billion from €500 billion, and to accelerate the payment schedule of ESM paid-in capital. The ESM is to be the main instrument to finance new programmes from July 2012. Euro area countries also commit €150 billion in additional bilateral contributions to the IMF. • Spain's government proposes a drastic reduction in budget spending of 16.9%, or €27 billion, after a 2011 fiscal deficit first estimated at 8.5% of GDP, but later revised to 9.6%.
17 April	IMF Managing Director Christine Lagarde says that Economic and Monetary Union requires 'a single bank resolution authority with a common backstop, and a single deposit insurance fund.'
20 April	At IMF and World Bank spring meeting, G20 countries agree that IMF resources to tackle the global financial crisis should be increased by \$430 billion.
25 April	IMF identifies a group of 10 Spanish banks that are vulnerable, including the country's largest mortgage lender, Bankia.
6 May	Greek parliamentary elections are held, but no majority winner emerges . Coalition talks fail, so new elections are set for June.
9 May	Spain's central bank confirms Bankia is to be partly nationalised .
15 May	Ecofin adopts general approach to transposing into EU law new Basel III capital requirements for banks and investment firms agreed at G20.
21 May	<ul style="list-style-type: none"> • Cyprus adopts legislation allowing it to underwrite Laiki Bank's €1.8 billion capital increase, in effect committing to purchase any shares not bought by private investors. • Spain commissions consultants Oliver Wyman to conduct an independent and comprehensive review of Spanish banks.

24 May	European Council reinforces commitment to safeguard financial stability.
30 May	European Commission's in-depth review of 12 member states identifies 'very serious imbalances' in Cyprus and Spain that need to be addressed urgently.
5 June	Spain's Treasury Minister Cristóbal Montoro says that Spain is having problems accessing credit markets.
17 June	Antonis Samaras wins election as Greek Prime Minister and takes office three days later.
19 June	G20 summit in Los Cabos, Mexico. Leaders urge Europe to shore up its financial foundations.
25 June	<ul style="list-style-type: none"> Spain asks the Eurogroup for financial assistance. Cyprus asks the Eurogroup for financial assistance.
26 June	European Council president publishes a report sketching out euro area reforms, such as banking union, including the direct recapitalisation of banks by the ESM, on which euro area leaders follow up at summit three days later.
29 June	At summit, euro area leaders call for the establishment of a Single Supervisory Mechanism (SSM) for euro area banks and plan to give the ESM a tool to recapitalise banks directly.
30 June	Having failed to attract sufficient private investment, Cyprus rescues Laiki Bank, making the €1.8 billion share purchase for an 84% holding in the bank.
20 July	Eurogroup approves Spanish programme for the recapitalisation of financial institutions, covering financing needs of up to €100 billion. The IMF contributes in an advisory fashion only.
26 July	<ul style="list-style-type: none"> Mario Draghi says that 'the ECB is ready to do whatever it takes to preserve the euro'. Ireland returns to international capital markets with a 5-year bond sale, raising €500 million.
6 September	ECB presents technical features of its outright monetary transactions programme to purchase secondary market sovereign bonds issued by euro area member states receiving financial assistance from the ESM/EFSSF.
12 September	German Federal Constitutional Court confirms that the ESM Treaty is constitutional.
15 September	Widespread protests across Portugal criticise the government's proposed increases in social security contributions, eventually forcing a U-turn.

27 September	ESM Treaty enters into force for 16 euro area member states after ratification by signatory countries, representing 90% of subscribed capital. For Estonia, it enters into force a week later, on 4 October.
28 September	Eurogroup president announces that Oliver Wyman's stress tests show that Spanish banks' capital shortfall is less than €60 billion.
Late September	The ratio of non-performing loans in Cypriot banks' Greek operations worsens to 42% of total loans, amounting to €19 billion (111% of GDP).
8 October	ESM is declared operational at first Board of Governors meeting in Luxembourg. Members begin making paid-in capital instalments.
16 November	Spain's FROB issues blueprint for Sareb as a 'bad bank'.
27 November	<ul style="list-style-type: none"> • Eurogroup overhauls Greece's second programme and endorses potential future debt relief measures. • EFSF sells 364-day €7 billion bond, opting for the unusual maturity because a credit-rating downgrade temporarily ruled out the issuance of bonds with maturities of one year and higher.
28 November	European Commission approves state aid and restructuring plans for several of Spain's key banks.
13 December	EU and ECB agree on banking supervision and SSM.
14 December	ESM moves to new premises in Kirchberg, Luxembourg, like the prior EFSF premises.
2013 1 January	ESM takes on EFSF employees.
8 January	ESM launches bill programme, shifting such sales away from EFSF.
21 January	Jeroen Dijsselbloem is appointed Eurogroup president, succeeding Jean-Claude Juncker.
23 January	Portugal returns to international capital markets with a syndicated tap, raising €2.5 billion.
24 February	Nicos Anastasiades is elected president of Cyprus. Negotiations over aid programme resume.
March	Independent PIMCO report into banking due diligence in Cyprus finds €10 billion shortfall.
4 March	Eurogroup agrees to work towards 'earliest possible completion of the loan agreement' for Cyprus.

16 March	Eurogroup reaches initial accord with Cyprus on aid package.
18 March	Fears of a bank run cause the Central Bank of Cyprus to declare a bank holiday, extended until 28 March.
19 March	Cypriot parliament rejects the aid agreement.
21 March	ECB warns it can't guarantee emergency funding for Cyprus beyond 25 March, unless a financial assistance deal is agreed with the EU/IMF.
25 March	Eurogroup approves a revised package for Cyprus. Under the new terms, the burden is shifted to depositors with holdings over €100,000.
28 March	Cyprus imposes capital controls, which are lifted two years later.
9 April	EFSF sells €8 billion in 5-year bonds, the largest-ever issue by a sovereign, supranational, and agency (SSA) borrower.
12 April	Eurogroup says agreement reached on the conditions of the ESM/IMF financial assistance for Cyprus, in line with 25 March package. Of the total €10 billion package, the ESM commits €9 billion and the IMF , €1 billion.
30 May	Two additional regulations, the two-pack, to strengthen budgetary discipline and economic surveillance in the euro area take effect , in addition to the six-pack.
1 July	<ul style="list-style-type: none"> • ESM becomes sole mechanism for new financial assistance programmes to euro area member states, while the EFSF continues to handle its outstanding loans. • Internal government disagreements in Portugal prompt the resignation of Finance Minister Vítor Gaspar. • Croatia joins EU, bringing membership to 28.
14 August	Eurostat says that euro area GDP grew by 0.3% in the second quarter, the first quarterly growth since the third quarter of 2011. Eurostat dates the recession from the third quarter of 2011 through the first quarter of 2013.
8 October	ESM begins long-term bond issuance, selling a 5-year €7 billion bond. The order book tops €20 billion.
22 October	Council of the European Union approves Romania's third precautionary programme following expiry of the second. The EU and IMF each put aside €2 billion for the programme, which runs until September 2015.
8 November	European Commission, ECB, and IMF say 'steadfast' implementation of reforms by Irish government, with above euro area average growth.

2014

8 December	Ireland successfully exits EFSF financial assistance programme.
11 December	European Parliament and EU Member States agree on the bank recovery and resolution directive (BRRD), the first step towards setting up an EU system to deal with struggling banks.
15 December	Ireland's IMF extended fund facility expires .
31 December	Spain successfully exits ESM banking sector financial assistance programme.
1 January	Latvia adopts the euro, bringing membership to 18.
18 March	<ul style="list-style-type: none"> • German Constitutional Court confirms preliminary 2012 ruling that upheld the constitutionality of the ESM Treaty and its transposition into German law. • Basel Committee on Banking Supervision recognises ESM and EFSF securities as Level 1 high quality liquid assets.
20 March	European Parliament and EU Member States reach political agreement on the Single Resolution Mechanism, allowing the orderly resolution of failing banks without costly taxpayer bailouts.
10 April	Greece returns to international capital markets with a 5-year bond sale, raising €3 billion.
30 April	ESM's 17 founding Members complete payment of the final tranche of paid-in capital.
2 May	Portugal obtains positive twelfth review and aims to conclude with a final June disbursement. Court blocks a key reform, ending the programme without the last disbursement.
5 May	European Commission takes note of Portugal's decision not to seek a precautionary aid programme.
17 May	European Commission, ECB, and IMF statement says Cyprus has taken steps towards implementing ambitious structural reform agenda.
18 May	Portugal successfully exits EFSF financial assistance programme.
18 June	Cyprus returns to international capital markets with a 5-year bond sale, raising €750 million.
30 June	Portugal's IMF extended fund facility expires .
8 July	Spain, after gaining ESM approval, makes a €1.3 billion voluntary prepayment on its ESM loan, the first in a series.

19 August	Regulation establishing a Single Resolution Mechanism for banks enters into force.
26 October	ECB publishes its year-long asset-quality review of the 130 largest euro area banks. Banks with a capital shortfall have two weeks to announce remedies and nine months to enact them.
4 November	SSM becomes operational. ECB assumes role of central banking supervisor of 130 largest euro area banks.
26 November	European Commission announces €315 billion investment plan, referred to as the 'Juncker plan'.
8 December	<ul style="list-style-type: none"> ESM Board of Governors adopts direct bank recapitalisation instrument, making it ready for use. Greek Prime Minister Antonis Samaras seeks early parliamentary appointment of next president.
29 December	Greek government collapses after failing to elect a new president.
31 December	Deadline for EU Member States to transpose into national law the single rulebook of the BRRD, which sets new rules for resolving troubled banks.
2015	
1 January	Lithuania adopts the euro, bringing membership to 19.
22 January	ECB introduces quantitative easing programme, buying European government bonds to boost the economy and inflation.
25 January	Syria party wins parliamentary election in Greece, and Alexis Tsipras becomes prime minister the next day.
4 February	ECB suspends eligibility of minimum credit-rating requirements for Greek bonds used as collateral in Eurosystem monetary operations.
20 February	Eurogroup agrees request to extend Greece's second programme by up to four months. EFSF Board of Directors follows up one week later, extending the programme to 30 June.
20 March	Ireland completes early repayment of part of its IMF assistance.
6 April	Cyprus lifts all capital controls.
8 April	Greek Prime Minister Alexis Tsipras goes to Moscow for talks with Russian President Vladimir Putin.
24 April	Eurogroup President Jeroen Dijsselbloem says that there are 'still wide differences' between the creditors and Greece.

12 May	To meet a €750 million debt repayment instalment to the IMF, Greece taps its IMF holding account .
3 June	French and German economy ministers say ESM should be brought under community law and transformed into a proper European Monetary Fund.
4 June	Greece informs IMF that it will delay a scheduled €300 million loan repayment.
11 June	IMF says there are 'major differences' with Greece, 'no progress in narrowing these differences recently'.
16 June	European Court of Justice rules that ECB's outright monetary transactions programme complies with EU law.
22 June	<ul style="list-style-type: none"> • Five Presidents' report on completing EMU is published. • Emergency euro summit tentatively welcomes Greek reform proposals but fails to reach agreement.
26 June	Greece abandons talks with creditors.
27 June	<ul style="list-style-type: none"> • Greek Prime Minister Alexis Tsipras calls referendum on financial assistance terms after the expiry of current loan agreement. • Eurogroup refuses to extend EFSF programme for Greece.
29 June	Greece imposes capital controls and closes banks.
30 June	<ul style="list-style-type: none"> • EFSF financial assistance programme for Greece expires. • Greece fails to make IMF loan repayment. • Eurogroup reconfirms its refusal to extend EFSF programme for Greece.
5 July	In a referendum , Greek voters reject creditors' rescue conditions.
6 July	Yanis Varoufakis resigns as Greek finance minister and is replaced by Euclid Tsakalotos.
8 July	Greece applies to the ESM for additional financial assistance.
10 July	European Commission and ECB recommend financial support to Greece because of the risk to the euro area.
12 July	Euro area leaders agree to start talks on third Greek programme, as long as Greece enacts immediate reforms.
16 July	Eurogroup decides to grant in principle a three-year ESM stability support programme to Greece, subject to conditions.

17 July	EU approves €7 billion EFSM bridge loan to Greece. Loan is facilitated by ESM private placement.
20 July	Greek banks reopen after a three-week shutdown.
4 August	EFSM lending terms are revised to shield its non-euro area member countries from financial loss in the event of non-repayment of loans to Greece, as agreed in decision to grant the bridge loan.
14 August	Eurogroup agrees Greece's third financial assistance programme.
18 August	Fitch upgrades Greek debt to CCC from CC, the first in a series of upgrades.
9 September	In his state of the union speech to the European Parliament, European Commission President Jean-Claude Juncker says the agreement with Greece should be 'a new start, for Greece and for the euro area as a whole'.
12 September	Eurogroup statement notes positive fiscal developments in Cyprus, financial improvements in banks and progress on growth-enhancing reforms.
20 September	Greek election confirms Syriza as the largest party; Alexis Tsipras remains prime minister.
13 October	ESM lengthens its maturity profile by selling its first 30-year bond, raising €3 billion.
24 November	<ul style="list-style-type: none"> European Commission makes legislative proposal to set up a European deposit insurance scheme in the euro area. ESM sells 40-year €1 billion bond, the first ultra-long benchmark issued by an SSA borrower.
1 January	Single Resolution Mechanism becomes fully operational.
15 January	Greece's IMF extended fund facility expires .
7 March	Cyprus's IMF extended fund facility is cancelled .
31 March	Cyprus successfully exits ESM financial assistance programme.
9 May	Eurogroup welcomes Greek reforms, and moves towards debt relief measures for Greece in the short, medium, and long term.
23 June	In a referendum, the UK votes to leave the EU (51.9% versus 48.1%).
5 December	Eurogroup endorses short-term debt relief measures for Greece including smoothing repayment profile and reducing interest rate risk.

2016

2017

8 December	ECB extends its quantitative easing programme.
23 January	ESM and EFSF approve short-term debt relief measures for Greece, which they implement throughout the year.
31 May	European Commission publishes a paper on deepening EMU, including proposals to add to the ESM's mandates.
15 June	<ul style="list-style-type: none"> • Eurogroup welcomes Greek fulfilment of agreed prior actions, paving the way for the successful completion of the second review of ESM programme. • First evaluation report of EFSF/ESM financial assistance programmes is published by Independent Evaluator Gertrude Tumpel-Gugerell.
20 July	IMF Executive Board approves in principle €1.6 billion stand-by arrangement for Greece.
25 July	Greece returns to international capital markets for the first time since 2014 with a 5-year bond sale, raising €3 billion.
24 October	ESM makes its debut in the dollar market, raising \$3 billion through the launch of a new 5-year bond.
13 November	European Commission in its report on ESM programme states that Greek government has widely outperformed fiscal targets, and launched important structural reforms in areas such as tax administration, business environment, energy, privatisation, and public administration.
6 December	European Commission sets out a roadmap for deepening EMU.
15 December	Leaders at euro summit decide to continue work on deepening EMU in 2018 on areas where convergence is visible: banking union and developing the ESM.
22 June	Eurogroup agrees to move ahead on medium-term debt relief measures for Greece, including maturity extensions and further deferral of EFSF interest. It also agrees to review whether or not additional measures are needed in 2032, the scheduled end of the EFSF repayment grace period.
29 June	Euro area leaders pledge to use ESM as Single Resolution Fund backstop, and ask finance ministers to prepare package of ESM reforms by December.
20 August	Greece successfully exits the ESM programme.

2018

16 October	Spain makes a €3 billion voluntary early repayment, its ninth, reducing Spain's outstanding debt to the ESM to €23.7 billion from the original €41.3 billion.
3 December	Eurogroup meets in inclusive format, including all EU Member States except the UK, to prepare package of ESM and monetary union initiatives ahead of leaders' summit.
4 December	EFSF approves waiver of Portugal's mandatory repayment of EFSF loans.
14 December	Euro area leaders agree on plan to strengthen ESM, create a bank resolution backstop and improve euro area governance, with proposal for ESM Treaty changes due by mid-2019.

EFSF and ESM disbursements

EFSF financial assistance to Ireland

Disbursement date	Amount disbursed	Cumulative amount disbursed	Initial final maturity	Final maturity
01/02/2011	€1.9 billion	€1.9 billion	18/07/2016	01/08/2032
01/02/2011	€1.7 billion	€3.6 billion	18/07/2016	01/02/2033
10/11/2011	€0.9 billion	€4.5 billion	04/02/2022	01/08/2030
10/11/2011	€2.1 billion	€6.6 billion	04/02/2022	25/07/2031
15/12/2011	€1.0 billion	€7.6 billion	23/08/2019	01/08/2030
12/01/2012	€1.2 billion	€8.8 billion	04/02/2015	01/08/2029
19/01/2012	€0.5 billion	€9.3 billion	19/07/2041	01/07/2034
03/04/2012	€2.7 billion	€12.0 billion	03/04/2037	01/08/2031
02/05/2013	€0.8 billion	€12.8 billion	02/05/2029	01/08/2029
18/06/2013	€1.6 billion	€14.4 billion	n.a	15/11/2042
27/09/2013	€1 billion	€15.4 billion	n.a	27/09/2034
04/12/2013	€2.3 billion	€17.7 billion	n.a	04/12/2033

Notes: Weighted average maturity: 20.8 years. See our website for more [information on financial assistance to Ireland](#).

Source: ESM

ESFS financial assistance to Portugal

Disbursement date	Amount disbursed	Cumulative amount disbursed	Initial final maturity	Final maturity
22/06/2011	€3.7 billion	€3.7 billion	05/07/2021	01/07/2036
29/06/2011	€2.2 billion	€5.9 billion	05/12/2016	03/12/2025
20/12/2011	€1 billion	€6.9 billion	23/08/2025	No change
12/01/2012	€1.7 billion	€8.6 billion	04/02/2015	30/01/2035
19/01/2012	€1 billion	€9.6 billion	19/07/2026	18/07/2027
30/05/2012	€3.5 billion	€13.1 billion	30/05/2032	30/05/2032
30/05/2012	€1.7 billion	€14.8 billion	30/05/2032	30/05/2035
17/07/2012	€1.5 billion	€16.3 billion	17/07/2038	17/07/2038
17/07/2012	€1.1 billion	€17.4 billion	17/07/2038	17/07/2040
03/12/2012	€0.8 billion	€18.2 billion	03/12/2028	03/12/2028
07/02/2013	€0.8 billion	€19 billion	07/02/2022	07/02/2026
27/06/2013	€1.05 billion	€20.05 billion	n.a.	27/06/2033
27/06/2013	€1.05 billion	€21.1 billion	n.a.	27/06/2034
22/11/2013	€3.7 billion	€24.8 billion	n.a.	22/11/2033
28/04/2014	€1.2 billion	€26 billion	n.a.	28/04/2038

Notes: Weighted average maturity: 20.8 years. See our website for more [information on financial assistance to Portugal](#).

Source: ESM

ESM financial assistance to Spain

Disbursement date	Amount disbursed	Cumulative amount disbursed	Type of disbursement	Final maturity
11/12/2012	€39.468 billion	€39.468 billion	Cashless	11/12/2027 *
05/02/2013	€1.865 billion	€41.333 billion	Cashless	11/12/2025 **

Notes: Weighted average maturity of loans: 12.49 years.

*Constant amortisation between 2022 and 2027 of €4.143 billion per year (amount adjusted following loan prepayments).

**Constant amortisation between 2024 and 2025 of €933 million per year. See our website for more [information on ESM financial assistance to Spain](#), including floating rate notes and loan repayments.

 Floating rate notes for Spain can also be found on page 228.

Source: ESM

ESM financial assistance to Cyprus

Disbursement date	Amount disbursed	Cumulative amount disbursed	Type of disbursement	Final maturity
13/05/2013	€1 billion		Cash	13/05/2026
	€1 billion	€2 billion	Cash	13/05/2027
26/06/2013	€1 billion	€3 billion	Cash	26/06/2028
27/09/2013	€750 million		Cashless	27/09/2029
	€750 million	€4.5 billion	Cashless	27/09/2030
19/12/2013	€100 million	€4.6 billion	Cash	19/12/2029
04/04/2014	€150 million	€4.75 billion	Cash	04/04/2030
09/07/2014	€600 million	€5.35 billion	Cash	09/07/2031
15/12/2014	€350 million	€5.7 billion	Cash	15/12/2025
15/07/2015	€100 million	€5.8 billion	Cash	15/07/2031
08/10/2015	€200 million		Cash	08/10/2029
	€300 million	€6.3 billion	Cash	08/10/2031

Notes: Weighted average maturity of loans: 14.9 years. See our website for more [information on ESM financial assistance to Cyprus](#), including floating rate notes.

Source: ESM

EFSF financial assistance to Greece

Overview of financial assistance

EFSF financial assistance for Greece comprised of:		Amount disbursed
Private sector involvement participation	Private sector involvement facility	€29.7 billion
	Accrued interest facility	€4.9 billion
Master Financial Assistance Facility Agreement	Bank recapitalisation	€37.3 billion
	Budget financing	€47.8 billion
	Debt buy-back	€11.3 billion
TOTAL		€130.9 billion

Notes: On 27/02/2015, the Hellenic Financial Stability Fund (HFSF) redelivered €10.9 billion in bonds issued by the EFSF for the recapitalisation of Greek banks. This comprised a full repayment of the €7.2 billion disbursed on 31/05/2013 and a partial repayment of €3.7 billion of the loan tranche disbursed on 19/12/2012). Prior to this, the full cumulative disbursed amount as of 14/08/2014 was €141.8 billion. See our website for more [information on EFSF financial assistance to Greece](#).

Source: ESM

Disbursed EFSF loan tranches to Greece and subsequent maturity extensions*

Disbursement date	Amount disbursed	Cumulative amount disbursed	Initial maturity	Maturity after first reprofiling (short-term measures)	Maturity after second reprofiling (medium-term measures)
09/03/2012	€34.6 billion	€34.6 billion	Amortisation from 2023 to 2042	(No change)	(No change)
19/03/2012	€5.9 billion	€40.5 billion	2047	Amortisation from 2045 to 2050	Amortisation from 2049 to 2070
10/04/2012	€3.3 billion	€43.8 billion	2041	2048	Amortisation from 2049 to 2070
19/04/2012	€25 billion	€68.8 billion	2018, 2019, 2020, 2021 and 2022 (interim maturities)	Amortisation from 2052 to 2056	Amortisation from 2049 to 2070 and from 2051 to 2070
10/05/2012	€4.2 billion	€73 billion	2042	2049	Amortisation from 2049 to 2070
28/06/2012	€1 billion	€74 billion	2040	2045	Amortisation from 2049 to 2070
17/12/2012	€7 billion	€81 billion	Amortisation from 2044 to 2046	Amortisation from 2046 to 2047	Amortisation from 2049 to 2070
17/12/2012	€11.3 billion	€92.2 billion	Amortisation from 2023 to 2042	(No change)	Amortisation from 2043 to 2049
19/12/2012	€16 billion	€108.2 billion	2022, 2023, 2024 (interim maturities)	Amortisation from 2051 to 2056	Amortisation from 2049 to 2070 and from 2051 to 2070
31/01/2013	€2 billion	€110.2 billion	2043	Amortisation from 2051 to 2053	Amortisation from 2049 to 2070

Disbursement date	Amount disbursed	Cumulative amount disbursed	Initial maturity	Maturity after first reprofiling (short-term measures)	Maturity after second reprofiling (medium-term measures)
28/02/2013	€2.8 billion	€113 billion	2043-2044	Amortisation from 2049 to 2050	Amortisation from 2049 to 2070
29/04/2013	€2.8 billion	€115.8 billion	2032	Amortisation from 2043 to 2044	Amortisation from 2049 to 2070
17/05/2013	€4.2 billion	€120 billion	2043	2050	Amortisation from 2049 to 2070
31/05/2013	€7.2 billion	€127.2 billion	(Loan repaid on 27/02/2015)		
25/06/2013	€3.3 billion	€130.5 billion	2045	Amortisation from 2051 to 2052	Amortisation from 2049 to 2070
31/07/2013	€2.5 billion	€133 billion	2048	Amortisation from 2047 to 2048	Amortisation from 2049 to 2070
18/12/2013	€500 million	€133.5 billion	2050	(No change)	Amortisation from 2049 to 2070
28/04/2014	€6.3 billion	€139.8 billion	2054	Amortisation from 2043 to 2045	Amortisation from 2049 to 2070
09/07/2014	€1 billion	€140.8 billion	2053	2054	Amortisation from 2049 to 2070
14/08/2014	€1 billion	€141.8 billion	2053	Amortisation from 2055 to 2056	Amortisation from 2049 to 2070
27/02/2015	€-10.9 billion**	130.9 billion***			

Notes:

*As a result of short-term and medium-term debt relief measures for Greece – approved by the EFSF Board of Directors in January 2017 and November 2018 – the EFSF loan tranches were reprofiled twice. This involved an extension of the loan maturities.

**On 27 February 2015, the Hellenic Financial Stability Fund redelivered €10.9 billion in bonds issued by the EFSF for the recapitalisation of Greek banks. This comprised: a full repayment of the €7.2 billion disbursed on 31 May 2013; and a partial repayment of €3.7 billion of the loan tranche disbursed on 19 December 2012.

***Outstanding loan amount.

Source: ESM

ESM financial assistance to Greece

Disbursement date	Amount disbursed	Cumulative amount disbursed	Type of disbursement	Maturity
20/08/2015	€13 billion	€13 billion	Cash	Amortisation from 2034 to 2057
24/11/2015	€2 billion	€15 billion	Cash	Amortisation from 2034 to 2057
01/12/2015	€2.7 billion	€17.7 billion	Cashless	Amortisation from 2055 to 2059
08/12/2015	€2.7 billion	€20.4 billion	Cashless	
23/12/2015	€1 billion	€21.4 billion	Cash	Amortisation from 2034 to 2057
21/06/2016	€7.5 billion	€28.9 billion	Cash	Amortisation from 2034 to 2058
26/10/2016	€2.8 billion	€31.7 billion	Cash	Amortisation from 2034 to 2058
10/07/2017	€7.7 billion	€39.4 billion	Cash	Amortisation from 2034 to 2059
30/10/2017	€0.8 billion	€40.2 billion	Cash	Amortisation from 2034 to 2059
28/03/2018	€5.7 billion	€45.9 billion	Cash	Amortisation from 2051 to 2054; 2060
15/06/2018	€1 billion	€46.9 billion	Cash	Amortisation from 2034 to 2060
06/08/2018	€15 billion	€61.9 billion	Cash	Amortisation from 2043 to 2060

Notes: Weighted average maturity of loans: 32.35 years (after repayments of €2 billion). See our website for more [information on ESM financial assistance to Greece](#), including floating rate notes and loan repayment.

Source: ESM

Floating rate notes issued by the ESM – Greece*

ISIN**	Issuance date	Amount issued	Type of disbursement	Maturity
EU000A1U9852	27/08/2015	€3 billion	FRN***	27/02/2017
EU000A1U9860	27/08/2015	€3 billion	FRN***	27/08/2017
EU000A1U9878	27/08/2015	€4 billion	FRN***	27/02/2018

Notes:

*The ESM issued floating rate notes to fund bank recapitalisation/resolution. Notes amounting to €5.4 billion were disbursed to Greece; the remaining €4.6 billion was not used and the notes were subsequently cancelled. The amount was disbursed pro rata in the ESM floating rate notes listed above.

**International Securities Identification Number.

***Floating rate note.

Source: ESM

Loan repayment – Greece

Date of repayment	Amount repaid	Details
20/02/2017	€2 billion	Contractual obligation following sale of assets of recapitalised National Bank of Greece

Source: ESM

Loan repayments – Spain

Date of repayment	Amount repaid	Cumulative amount repaid	Details
08/07/2014	€1.304 billion	€1.304 billion	Early repayment (voluntary)
23/07/2014	€0.308 billion	€1.612 billion	Scheduled repayment of unused funds
17/03/2015	€1.5 billion	€3.112 billion	Early repayment (voluntary)
14/07/2015	€2.5 billion	€5.612 billion	Early repayment (voluntary)
11/11/2016	€1 billion	€6.612 billion	Early repayment (voluntary)
14/06/2017	€1 billion	€7.612 billion	Early repayment (voluntary)
16/11/2017	€2 billion	€9.612 billion	Early repayment (voluntary)
23/02/2018	€2 billion	€11.612 billion	Early repayment (voluntary)
23/05/2018	€3 billion	€14.612 billion	Early repayment (voluntary)
16/10/2018	€3 billion	€17.612 billion	Early repayment (voluntary)

Source: ESM

 Floating rate notes for Spain can be found on page 228.

EFSF and ESM rating history

EFSSF

Moody's

Date	Rating/outlook	Rating action
7 May 2018	Aa1 / Positive	Change of outlook to positive
6 Jun 2014	Aa1 / Stable	Change of outlook to stable
30 Nov 2012	Aa1 / Negative	Downgrade
25 Jul 2012	Aaa / Negative	Change of outlook to negative
20 Sep 2010	Aaa / Stable	New rating

Fitch

Date	Rating/outlook	Rating action
16 Dec 2014	AA	Downgrade and end of rating on watch
15 Oct 2014	AA+ / On watch negative	Rating on watch for downgrade
15 Jul 2013	AA+	Downgrade
20 Sep 2010	AAA	New rating

Standard & Poor's

Date	Rating/outlook	Rating action
25 Oct 2016	AA / Stable	Change of outlook to stable
10 Oct 2014	AA / Negative	Change of outlook to negative
8 Nov 2013	AA / Stable	Downgrade and change of outlook to stable
27 Feb 2012	AA+ / Negative	Change of outlook to negative
16 Jan 2012	AA+ / Developing	Downgrade and outlook developing
6 Dec 2011	AAA / On watch negative	Rating on watch for downgrade
20 Sep 2010	AAA	New rating

DBRS*

Date	Rating/outlook	Rating action
27 July 2012	AAA / Stable	New rating

* Unsolicited rating

ESM

Moody's

Date	Rating/outlook	Rating action
7 May 2018	Aa1 / Positive	Change of outlook to positive
6 Jun 2014	Aa1 / Stable	Change of outlook to stable
30 Nov 2012	Aa1 / Negative	Downgrade
8 Oct 2012	Aaa / Negative	New rating

Fitch

Date	Rating/outlook	Rating action
16 Dec 2014	AAA / Stable	Affirmation and end of rating on watch for downgrade
15 Oct 2014	AAA / On watch negative	Rating on watch for downgrade
8 Oct 2012	AAA / Stable	New rating

DBRS*

Date	Rating/outlook	Rating action
4 April 2014	AAA / Stable	New rating

* Unsolicited

Loan re-profiling for Greece, Ireland, and Portugal

Euro area efforts to aid member countries evolved during the crisis. From the earliest days of the EU's Greek Loan Facility in 2010 until 2018, the institutions have sought to design and, if necessary, amend assistance programmes to help recipient countries return to market access and debt sustainability. For Greece, Ireland, and Portugal, this has meant adjusting the lending terms on which financial assistance was offered.

11 March 2011

Greek Loan Facility (GLF)

Euro area leaders agree to extend the maturity of aid loans to Greece to 7.5 years and lower the interest rate margin by 100 basis points. At the time, Greece's aid loans came from the GLF.

EFSF assistance

Euro area leaders agree that 'Pricing of the EFSF should be lowered to better take into account debt sustainability of the recipient countries, while remaining above the funding costs of the facility'.

June 2011

Greek Loan Facility

Greek Loan Facility amended, in keeping with changes agreed in March 2011

- Loan maturities: Extended by five to 10 years
- Grace period: Lengthened to 4.5 from three years
- Interest rate margin: Lowered by 100 basis points, to 2% in the first three years and 3% thereafter.

21 July 2011

Greek Loan Facility

Euro area leaders agree to extend substantially the maturities of the existing Greek facility.

EFSF assistance

Euro area leaders agree to reduce the interest rates and extend the maturities on existing EFSF aid loans to Portugal and Ireland in line with the rate and maturity changes agreed for Greece.

Leaders also agree to longer loans and repayment grace period for future EFSF loans to Greece. They extend loans to a minimum of 15 and a maximum of 30 years, from 7.5 years, lengthen the Greek grace period to 10 years, and set interest rates at the equivalent of the EU's balance of payments facility, about 3.5% at the time.

11 October 2011	<p>EFSM assistance Council of the European Union extends maturity of EFSM loans to Ireland and Portugal to up to 12.5 years on average. Council also reduces interest rate margins to EU's cost of funding.</p>
28 November 2011	<p>EFSE assistance The EFSE initially used a simple back-to-back funding approach; lending rates were to be equivalent to those for EU balance of payments Facilities and should be close to, without going below, the EFSE funding cost. In November 2011, however, the EFSE adopted a diversified funding strategy, to cover its funding costs. One consequence of the diversified funding strategy is that funds raised are no longer attributed to a particular country. The funds are pooled and then disbursed to programme countries upon request.</p>
21 February 2012	<p>Greek Loan Facility Eurogroup agrees to second adjustment of lending terms for Greek aid received under the GLF, retroactive to June 2011.</p> <ul style="list-style-type: none"> • Interest rate margin to be reduced to 150 basis points. • Euro countries asked to complete national procedures to ratify these changes as soon as possible.
March 2012	<p>Greek Loan Facility Second amendment to GLF, including interest rate changes agreed in February.</p> <ul style="list-style-type: none"> • Loan maturities: Extended to 15 from 10 years • Grace period: Lengthened to 10 from 4.5 years • Interest rates: Lowered to 150 basis points over the entire period from previous level of 2% in the first three years and 3% thereafter. <p>Other actions The IMF says Greece will end its stand-by arrangement aid programme and move to an extended fund facility, which provides for a longer engagement and repayment period.</p>

27 November 2012	<p>Greek Loan Facility Eurogroup agrees on adjustments to Greece's aid programmes.</p> <p>GLF adjustments:</p> <ul style="list-style-type: none"> • Interest rate: Reduced to 50 from 150 basis points • Loan maturities: Extended to 30 from 15 years 	<p>EFSS assistance Eurogroup agrees on adjustments to Greece's aid programmes EFSS adjustments:</p> <ul style="list-style-type: none"> • Guarantee commitment fee: decreased by 10 basis points and set to 0 • Interest payments: Deferred on loans under the Greek Master Financial Assistance Facility Agreement by 10 years • Loan maturities: weighted average maturities extended by 15 years to 32.5 from 17.5 years. 	<p>Other actions Eurogroup pledges to consider 'further measures and assistance' if Greece meets fiscal targets in the future. Other steps taken include:</p> <ul style="list-style-type: none"> • Eurogroup agrees to return to Greece any Securities Markets Programme (SMP) profits, from when the ECB bought Greek government bonds at a discount in the secondary market and made a profit at maturity. They commit to pass on to Greece's segregated account an amount equivalent to the income on the SMP portfolio accruing to their national central bank as from budget year 2013. • Member states under a full financial assistance programme were not required to participate in the assistance measures.
21 June 2013	<p>EFSS assistance EU finance ministers decide to implement second extension of maturity of EFSS loans to Ireland and Portugal by up to seven years, to 19.5 from 12.5 years on average.</p>		
24 June 2013	<p>EFSS assistance EFSS Board of Directors decides to implement second extension of maturity of EFSS loans to Ireland and Portugal by up to seven years to up to 22 years on average.</p>		
12 July 2015	<p>ESM assistance Euro area leaders pledge that if Greece receives a new aid programme and meets its policy commitments, additional debt relief steps may be taken that would include longer maturities and grace periods, but not writedowns on the outstanding assistance loan principal.</p>		

9 May 2016

Other actions

Eurogroup agrees on series of short-, medium-, and long-term measures to relieve Greece's debt burden, provided Greece meets commitments as foreseen by leaders in July 2015

- Short term: Possibilities to optimise debt management of the programme.
- Medium term: Explore measures, such as longer grace and payment periods, at end of successful ESM programme.
- Long term: Assess need for additional debt measures to ensure sustainable gross financing needs.

The Eurogroup reconfirms that nominal haircuts are excluded.

5 December 2016

Other actions

Eurogroup endorses set of **three short-term debt relief measures** for Greece, which are then **approved by EFSF and ESM** on 23 January 2017. These include:

1. Smoothing Greece's repayment profile under its EFSF programme within the current weighted average maturity of up to 32.5 years
2. Reducing interest rate risk, includes:
 - A bond exchange – floating rate notes disbursed by the ESM to Greece for bank recapitalisation are exchanged for fixed coupon notes.
 - ESM swap arrangements to reduce the risk that Greece will have to pay a higher interest rate on its loans when market rates start rising.
 - 'Matched funding' – issuing long-term bonds that closely match the maturity of the Greek loans, and implies the ESM charging a fixed rate on part of any future disbursements to Greece.
3. Waiving the step-up interest rate margin for 2017, amounting to 200 basis points related to the €11.3 billion debt buy-back instalment of the second Greek programme for the year 2017.

22 June 2018

Other actions

Eurogroup agrees to medium-term debt-relief measures, provided Greece meets its policy commitments. These include:

- Abolition of the step-up interest rate margin related to the debt buy-back tranche of the second Greek programme as of 2018.
- Authorised use of 2014 SMP profits from the ESM segregated account and restoration of the transfer of SMP and other central bank income equivalent amounts to Greece, as of budget year 2017. Available income equivalent amounts will be transferred to Greece in equal amounts on a semi-annual basis in December and June, starting in 2018 until June 2022.

In addition:

- Further deferral of EFSF interest and amortisation by 10 years and an extension of the maximum weighted average maturity by 10 years, respecting the programme authorised amount.
- Agreement to review whether additional measures are needed in 2032, the scheduled end of the EFSF repayment grace period.

Acronyms and abbreviations

ALM	Asset and liability management
BRRD	Bank recovery and resolution directive
DRI	Direct recapitalisation instrument
DSA	Debt sustainability analysis
ECB	European Central Bank
Ecofin	Economic and Financial Affairs Council, body comprising EU economic and finance ministers
EFSF	European Financial Stability Facility
EFSM	European Financial Stabilisation Mechanism
EIB	European Investment Bank
EMU	Economic and Monetary Union
ESM	European Stability Mechanism
EU	European Union
Euribor	Euro interbank offered rate
Eurogroup	Recognised informal body, comprising of euro area member states' finance ministers
Eurosystem	Euro area monetary authority, comprising ECB and euro area national central banks.
FROB	Spain's Fondo de reestructuración ordenada bancaria, or Fund for Orderly Bank Restructuring.
G20	International forum of 19 countries plus EU
GDP	Gross domestic product
GLF	Greek Loan Facility
IFI	International financial institution
IMF	International Monetary Fund
KfW	Germany's state-backed development bank
Libor	London interbank offered rate
NPL	Non-performing loan
OJ	Official Journal of the European Union

PSI	Private sector involvement
RFAs	Regional financing arrangements
Sareb	Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria – Spain’s ‘bad bank’.
SMP	Securities Markets Programme
SSA	Sovereign, supranational, and agency
SSM	Single Supervisory Mechanism
SWIFT	Society for Worldwide Interbank Financial Telecommunications
TARP	Troubled Asset Relief Program

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European Stability Mechanism



The European Stability Mechanism and its temporary predecessor the EFSF provided billions of euros in loans to five hard-hit euro area countries during the European financial and sovereign debt crisis of the early 2000s, helping to safeguard the stability of those countries and the euro area as a whole.

This book tells the inside story of those who played key roles in setting up the organisations and combatting the crisis. In exclusive interviews, global financial leaders and ESM insiders provide a rich stock of perspectives and anecdotes that bring to life the urgency of the crisis as well as the innovative solutions found to resolve it.

Initially, the crisis-torn euro area was ill-equipped institutionally, but the rapid establishment of the firewalls, the assistance programmes, deep-seated country reforms, the strengthening of European institutions, and extraordinary European Central Bank measures shielded Europe from a euro area break-up.

With the EFSF/ESM set-up, its managers aspired to create a new, more entrepreneurial international financial institution, one that is agile enough to respond quickly to new challenges, while still ensuring the strict governance befitting an organisation pursuing a public mission.

The euro area has emerged from near disaster in more robust shape. As Europe strives to further strengthen its architecture in preparation for any possible future crises, it is important to reflect upon how the euro area reinvigorated its fortunes and draw the relevant lessons for future crisis management in Europe and beyond.



Publications Office

Print

ISBN 978-92-95085-34-3

doi:10.2852/47298

DW-06-16-056-EN-C

PDF

ISBN 978-92-95085-33-6

doi:10.2852/788601

DW-06-16-056-EN-N