Annual Report

2022

European Stability Mechanism

esm

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Annual Report

Letter of transmittal to the Board of Governors

15 June 2023

Dear Chairperson,

I have the honour of presenting to the Board of Governors the annual report in respect of the financial year 2022, in accordance with Article 23(2) of the European Stability Mechanism By-Laws (By-Laws).

The annual report includes a description of the policies and activities of the European Stability Mechanism (ESM) during 2022. It also contains the audited financial statements as at 31 December 2022, as drawn up by the Board of Directors on 30 March 2023 pursuant to Article 21 of the By-Laws, which are presented in Chapter 4. Furthermore, the report of the external auditor in respect of the financial statements is presented in Chapter 5 and the report of the Board of Auditors in respect of the financial statements in Chapter 6. The independent external audit was monitored and reviewed by the Board of Auditors as required by Article 24(4) of the By-Laws.

Pierre Gramegna
Managing Director

Note: The description of ESM policies and activities covers the 2022 financial year, except when stated otherwise. The information related to the composition of the Board of Governors, Board of Directors, and Board of Auditors reflects their composition as of 21 April 2023. The economic development report (Chapter 1) includes certain information available up to 21 April 2023, but all historical financial data are limited to the period to 31 December 2022.

Contents

ESM at a glance

The ESM is a crisis resolution mechanism established by the euro area countries. Since its inception in October 2012, the Luxembourg-based institution has provided financial assistance to ESM Members experiencing or threatened by severe financing problems to safeguard the financial stability of the euro area as a whole and of its member states. The ESM raises funds by issuing debt instruments in the capital markets, which are purchased by institutional investors.

On 30 November 2020, the Eurogroup agreed to proceed with a reform of the ESM and all ESM Members signed the agreement amending the ESM Treaty by February 2021. The reform includes refining the ESM precautionary instruments, enhancing the ESM's role in programme management associated with financial assistance, and providing a common backstop for the Single Resolution Fund. The reform will come into force following the ratification of the amended ESM Treaty by all ESM Members.

The ESM grants financial assistance to its Members with conditions that are in line with the financial assistance instrument chosen. The ESM has a number of financial assistance instruments:

- Loans to cover ESM Members' financing needs
- Loans and direct equity injections to recapitalise financial institutions
- Primary and secondary debt market purchases of Members' national bonds
- Credit lines to be used as precautionary financial assistance

Following the ratification of the amended ESM Treaty, the common backstop for the Single Resolution Fund will replace the direct bank recapitalisation instrument. The ESM will be able to disburse up to €68 billion to the Single Resolution Fund under this credit line if the Single Resolution Fund is depleted and certain other criteria are fulfilled.

The ESM has used two financial assistance instruments to date: ESM loans and loans to recapitalise financial institutions. In total, the ESM and its predecessor, the European Financial Stability Facility (EFSF), have together disbursed €295 billion to five Members: Ireland, Greece, Spain, Cyprus, and Portugal.

WWW For more information about the ESM, visit www.esm.europa.eu.

2022 year in review

22 FEB

EFSF Board of Directors approves reduction to zero of the step-up margin accrued by Greece between 17 June 2021 and 1 January 2022 as part of the medium-term debt relief measures agreed in 2018, saving Greece €122.5 million.

28 MAR

ESM and EFSF Boards of Directors approve the waiver of Greece's mandatory prepayment obligation of ESM/EFSF loans tied to its early repayment to the International Monetary Fund and of the Greek Loan Facility.

17-18 MAY

With the ASEAN+3 Regional Macroeconomic Office (AMRO) and the Latin American Reserve Fund (FLAR), the ESM co-organises the ***6th Joint Regional Financing Arrangements (RFAs) Research Seminar*** *on international capital flows and spillovers, in partnership with the Indonesian G20 Presidency.*

16 JUN

At its 10th Annual Meeting, the ESM Board of Governors approves the **2021 Annual Report**. It also maintains the maximum lending volume at €500 billion and the authorised capital stock constant, while taking note of the intention to conclude a more comprehensive review, which will include a review of the ESM financial assistance instruments, by Q1 2024. In addition, it approves the allocation of funds towards the construction of a new ESM headquarters.

15 JUL

EFSF Board of Directors approves the reduction to zero of the step-up margin accrued by Greece from 1 January 2022 to 17 June 2022.

6 OCT

ESM Board of Governors appoints Christophe Frankel as ESM Managing Director for an interim period from 8 October 2022 to 31 December 2022, or such earlier date as a new Managing Director takes office.

ESM Board of Governors appoints Giovanni Coppola and Helga Berger to the ESM Board of Auditors, for non-renewable three-year terms starting on 8 October and 17 December 2022, respectively.

7 OCT

ESM Managing Director Klaus Regling's second and final mandate expires after 10 years with the institution. He also steps down as CEO of the EFSF.

12 OCT

ESM Secretary General Nicola Giammarioli represents the ESM at the ***7th High-level RFA Dialogue*** *held in Washington DC.*

24 OCT

EFSF Board of Directors appoints Christophe Frankel as CEO.

25 NOV

ESM Board of Governors ***appoints Pierre Gramegna as Managing Director*** *for a five-year term, with effect from 1 December 2022.*

5 DEC

ESM Board of Governors ***approves Croatia's accession to the ESM****, the related amendments to the ESM Treaty, and the adjustment of the contribution key following the end of Estonia's temporary correction.*

ESM Board of Governors approves new external auditor for the financial years 2023–2025.

13 DEC

EFSF Board of Directors appoints Pierre Gramegna as CEO.

Message from the

"Over 10 years and with more than €400 billion in firepower still on hand, the ESM has made a vital contribution to steering Europe's monetary union through the troubles of the past and stands ready to avert and absorb new shocks. Building upon the ESM's past experiences and aware of the challenges ahead, I am eager to work with our 20 member countries to shape the ESM around the euro area's evolving needs."

Pierre Gramegna
Managing Director
European Stability Mechanism

Managing Director

In 2022, the ESM marked its 10th anniversary. Established on 8 October 2012, it filled an important gap in the euro area architecture and, through its mission, has contributed to maintaining the euro area's financial stability and prosperity.

This anniversary is a good opportunity to both look at past achievements and look ahead at the future, in this my first message as Managing Director.

Safeguarding the integrity of the euro area

Fifteen years ago, the global financial crisis triggered a global economic recession. What started in US financial institutions in 2007, quickly spread to the rest of the world. This crisis brought to the fore weaknesses in the setup of the euro area, which had not been anticipated and put the integrity of our monetary union in jeopardy.

Lacking a lender of last resort for sovereigns, the EFSF was created in 2010 as a temporary instrument and provided emergency financial assistance to Ireland, Portugal, and Greece. Two years later, euro area member states established the ESM as a permanent mechanism to help euro area countries avoid and overcome financial crises. It provided financial support to Spain, Cyprus, and Greece.

In total, the EFSF and the ESM together lent close to €300 billion, playing a critical role in safeguarding the integrity of the euro area. These loans helped beneficiary countries rebalance their budgets and shore up their economies. The implementation of key structural reforms by affected countries, and the implementation of unprecedented monetary policy measures by the European Central Bank (ECB), also played an essential role in this respect.

In retrospect, it appears the ESM's financial support proved successful, even though the accompanying economic adjustment programmes came – at times – with social costs. All the institutions involved must learn lessons from these experiences.

Putting the crises to good use

The global financial and euro crises prompted essential changes to the European Union (EU) and euro area architecture.

In 2011, the European System of Financial Supervision was established. Along with three sectoral supervisory authorities – for banks, markets, and insurance companies[1] – the EU established a macroprudential authority to monitor risks to the financial systems across the Union.[2] In 2014, the Single Supervisory Mechanism brought the supervision of systemically important banks to the European level. Shortly after, the Single Resolution Board was established as a central resolution authority, together with its financial arm, the Single Resolution Fund.

The value of these enhancements to Europe has been proven beyond question in two subsequent crises over the past three years. The Covid-19 pandemic caused both human and economic losses, but the banking system, more strongly capitalised, became part of the solution rather than part of the problem. Backed by public guarantees, bank lending kept our economies afloat. At the European level, measures were taken by the European Commission, the European Investment Bank, and the ESM to support respectively workers, businesses, and countries. The ESM participated in this historic act of European solidarity by providing a credit line of up to €240 billion. Although not tapped by the time it expired end-2022, its mere existence helped reassure capital markets, to which all ESM Members retained full access.

1 The European Banking Authority, the European Securities and Markets Authority, and the European Insurance and Occupational Pensions Authority.
2 The European Systemic Risk Board.

The European Commission's Next Generation EU package also provided crucial support to member countries by supporting the green and digital transition of their economies.

Even as the pandemic was fading, the world, and Europe in particular, faced yet another crisis. Since Russia's invasion of Ukraine in February 2022, another human tragedy has unfolded before our eyes. This new crisis has brought a new set of serious economic challenges. High inflation emerged amid the severe supply chain disruptions caused by the public health lockdowns and was quickly amplified by soaring energy prices.

Once again, the EU's response was steadfast. Member States have provided fiscal support to shield citizens from the rising energy prices. The REpowerEU programme has also helped in diversifying energy supplies away from Russian gas, bringing prices down in the process. The EU and the euro area have again proven more resilient than many expected.

The path ahead and the role of the ESM

For all that resilience, we need to remain vigilant. As history shows, crises will occur. EU fiscal rules will have to become more effective, credible, and supportive of growth and investment, while keeping public debt, which increased substantively during the pandemic, in check. The pandemic has illustrated that Europe will continue to face different types of crises that can strike all euro area countries simultaneously. Reflections are underway to assess how the ESM can be even more useful in such circumstances.

Strengthening the euro area architecture is key for this. Against this backdrop, proposals have been put forward on how to generate additional fiscal space at the euro area level.

Despite the difficulties it has encountered, completing banking union should remain an objective. New impetus is also needed in the capital markets union project. To reap the full benefits of our single currency, Europe needs to converge towards a true single capital market. Today, fragmented national markets in Europe remain a hurdle for international investors.

The ESM is committed to cooperating with other institutions to advance these endeavours. It is ready to support its member countries, and not only to manage crises but to prevent them – a much less costly option.

Upon my appointment as Managing Director on 1 December 2022, my first decision was to engage with all our shareholders to listen to their views on how the ESM can best support them. The ongoing ratification of the amended ESM Treaty, through which, notably, the ESM would provide the backstop for the Single Resolution Fund, provides the right context for this. The input of our shareholders will be essential in determining how the ESM will evolve within its new mandate.

I would like to take this opportunity to thank all the ESM Members for the support and trust displayed when they decided to appoint me as Managing Director. I committed from that day to fulfil my task with dedication, diligence, and dynamism, and will take inspiration from my predecessor, Klaus Regling. As the first Managing Director, who led the institution for 10 years, Klaus embodied the ESM's mission and stood out as a pioneer and tireless leader. I would like to express my gratitude to him for his support and advice, as well as to the whole ESM team that received me with open arms, enthusiasm, and a high degree of professionalism.

From crisis to confidence: how more than a decade of shocks forged a steelier euro area

Today, the euro area is larger, more robust, and better equipped to face new challenges compared to a decade ago. A succession of crises – the euro area sovereign debt crisis, the Covid-19 pandemic, and most recently the energy price shock exacerbated by Russia's invasion of Ukraine – has seen the euro area build up its resources for managing economic emergencies, as the economic and monetary union has evolved from ad hoc solutions to permanent institutions that protect the single currency.

The 2008 global financial crisis and the ensuing euro area sovereign debt crisis exposed the limited capacity that the decade-old currency union then had in place for crisis resolution. As many international investors stopped lending to some euro area countries, national policy responses required the solidarity of the bloc as a whole. The first financial assistance package took the form of coordinated bilateral loans to Greece from other euro area member states in May 2010. EU Member States also established the European Financial Stabilisation Mechanism, an emergency fund backed by the EU budget. While this provided a multilateral financial assistance framework, its capacity proved insufficient. In June 2010, the euro area established a much larger, temporary rescue fund, the EFSF. This provided the bulk of financing needed for Ireland, Greece, and Portugal from 2011 to 2013. Yet it became clear that a more permanent solution was urgently needed.

The establishment of the ESM in 2012 gave markets confidence that the sovereign debt crisis could be effectively resolved. The ESM brought a more robust and permanent institutional and capital structure to the euro area's crisis management system. With its lending capacity of €500 billion, the ESM replaced the temporary EFSF and went on to provide further loans to Greece as well as to Spain and Cyprus between 2012 and 2018.

Policy responses by other institutions worked in tandem with the setting up of the ESM. In August 2012, the ECB announced the introduction of Outright Monetary Transactions – limitless firepower available if needed, to safeguard the monetary policy transmission mechanism, to any country that agreed on a programme with the ESM. A concerted European effort convinced markets that the authorities would do whatever it took to preserve the integrity of the euro.

In addition, the euro area enhanced important elements of its economic governance and put its financial stability on sounder footing. Financial regulation and fiscal and economic policy coordination were tightened and together with strong national policies helped reduce macroeconomic imbalances and vulnerabilities in the financial sector. The Single Supervisory Mechanism was set up as the first pillar of banking union in November 2014. The second pillar, the Single Resolution Mechanism, manages bank failures and breaks potential vicious circles between banks and sovereigns. A backstop for its Single Resolution Fund provided by the ESM was part of the ESM reform, as reflected in the agreement amending the ESM Treaty, which all ESM Members signed by February 2021. It will be fully operational once the amended ESM Treaty enters into force. Work continues on the completion of banking union and further deepening capital markets union.

Having learned the lessons from the sovereign debt crisis, Europe was quick to react to the pandemic crisis. The sharp downturn caused by the virus required EU-wide crisis mitigation rather than the rescue of certain Member States. The ESM, the European Commission, and the European Investment Bank introduced an emergency package worth €540 billion to support governments, households, and firms in May 2020. It included the ESM's €240-billion Pandemic Crisis Support credit line designed to help ESM Members cover Covid-19 healthcare-related costs (see Pandemic Crisis Support signals ESM's commitment to its mission). The ECB also broadened its toolkit by offering more favourable longer-term refinancing operations and deployed a new pandemic-related purchase programme. These initiatives gave the EU time to agree on the €800-billion Next Generation EU instrument to support the economic recovery from the pandemic and facilitate the digital and sustainable transformation of national economies.

Today, Europe's commitment to addressing economic challenges is once more being tested. The revised economic governance will increase euro area resilience and promote reforms and investment. Russia's invasion of Ukraine amplified the already accelerating post-pandemic inflation. New measures were introduced to counter a new risk of fragmentation. In July 2022, the ECB announced the Transmission Protection Instrument to contain disorderly market dynamics threatening the smooth transition of monetary policy normalisation. The ESM's assessment of countries' debt sustainability provides one input to the possible activation of the ECB's latest instrument. In addition, the European Commission's REPowerEU plan, which builds on the Next Generation EU framework, aims to further diversify energy supplies away from Russia to foster energy savings and accelerate the roll-out of renewable energy.

The euro area has overcome three crises since 2009, emerging more integrated and resilient. Europe's resolve to take joint action was necessary to protect the currency union and has nurtured trust both at home and internationally. A rapid and resolute European response to crises lies at the heart of the ESM's mission and over the past decade it has demonstrated force and agility to fulfil that mission. The agreement making the ESM the provider of the common backstop for the Single Resolution Fund will further strengthen its ability to prevent and tackle future crises, upon ratification of the Amending Agreement of the ESM Treaty.

"Numbering just 10 people when I started, we built a safety boat in the midst of a storm, saving countries and learning along the way. Today, our weather-tested rescue ship is trusted by international markets and European nations to ensure financial stability for 350 million euro area citizens."

Kalin Anev Janse
Chief Financial Officer

ESM strategises yearly to achieve institutional priorities

Each year, ESM management sets strategic priorities directly linked to the institution's mission of safeguarding euro area financial stability for the coming years. These priorities guide the allocation of resources to ensure concerted efforts towards achieving the ESM's mission.

The strategic framework is one of many tools used to ensure good organisational governance to act in the best interests of its stakeholders and in line with the environmental, social, and governance (ESG) pillar within that framework.

For 2022, the ESM set the following strategic priorities:

1. To make the ESM operationally ready to execute its enhanced mandate as agreed in the context of the ESM Treaty reform and, within this mandate, to add value for shareholders in non-crisis times.

2. To enhance organisational efficiency, readiness, and resilience, and to thrive in the post-pandemic work environment.

3. To integrate ESG and climate change considerations in all activities.

In 2022, the ESM, in collaboration with the Single Resolution Board, implemented key identified lessons resulting from a dry-run exercise conducted in 2021 to ensure operational readiness to act as the backstop for the Single Resolution Fund. The ESM also prepared all the processes and tools required to perform the enhanced level of macroeconomic analysis needed for its upcoming new role and successfully prepared for Croatia's accession to the ESM.

After an extensive testing period, the ESM rolled out its hybrid work framework with adapted processes, technology, and office design to fit the post-pandemic working environment and help staff thrive in it. In that vein, the ESM adjusted its behavioural framework that lays out the behaviours the ESM values for the successful preservation of its internal culture. In addition, the ESM relocated and enhanced its disaster recovery site to strengthen business continuity measures.

The ESM has progressed considerably in integrating ESG considerations into all its activities, with great strides made in incorporating climate risks into its economic analyses, risk assessment frameworks, and programme design. In line with the commitment coming from signing the United Nations (UN)-backed Principles for Responsible Investment in 2020, the ESM has access to dedicated ESG data from an external provider to support its investment decision-making and monitor the ESG score of its paid-in capital portfolio. For more information, see ESM enhances its responsible investment approach by monitoring the ESG score of its paid-in capital.

01

Economic developments

Macroeconomic and financial environment

Rising inflation and risk of recession

Global economic growth trailed its historical average in 2022 as the outbreak of the war in Ukraine further disrupted energy and commodity markets and China imposed pandemic-related lockdowns. Rising inflation forced central banks around the world to tighten monetary policy. Despite these challenges, euro area economic activity remained resilient overall in 2022, turning in a strong performance in the first half of the year as economies recovered from the pandemic. However, inflation and external risks weighed on growth, particularly in the second half of the year. Funding conditions for households, corporates, and sovereigns tightened as the ECB began winding down its accommodative monetary policy. On the upside, euro area member states benefitted from disbursements under the Next Generation EU instrument and labour markets remained resilient. While the EU Member States and institutions continue working on the revised fiscal framework, the European Commission provided guidance on Member States' fiscal policies for 2024.

Global economic activity slowed markedly in 2022 amid geopolitical uncertainty and soaring inflation, as well as strict Covid-19 containment measures in China. Following the post-pandemic rebound (+6.3% in 2021), world gross domestic product (GDP) grew modestly by 3.4% in 2022 (Figure 1). Russia's invasion of Ukraine caused human suffering and triggered economic and financial market volatility. The global growth slowdown was exacerbated by a tightening of monetary policy to counter high inflation and the withdrawal of pandemic-related fiscal support for households and firms. Global trade expanded by 5.1% in 2022 after the previous year's 10.6% rebound (Figure 1), fuelled by the waning Covid-19 pandemic and receding supply-side disruptions.

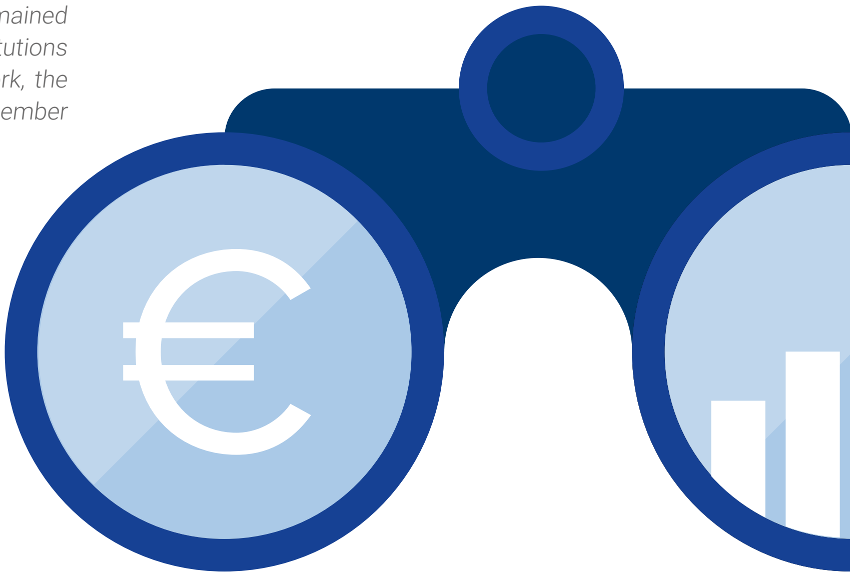
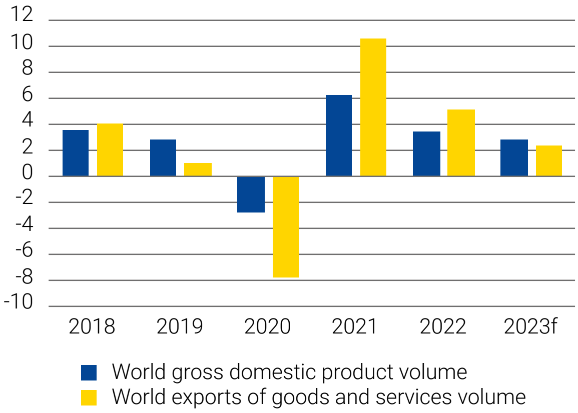
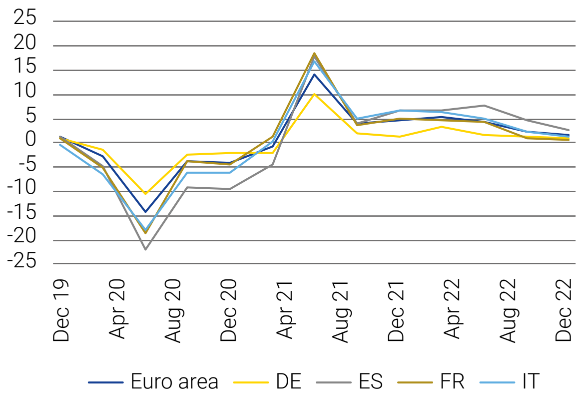


Figure 1
Global economic activity and exports of goods and services
(volume, year-on-year, in %)



Note: f = forecast.
Source: International Monetary Fund World Economic Outlook, April 2023

Figure 2
Real gross domestic product growth for selected countries
(year-on-year growth in %, quarterly data)

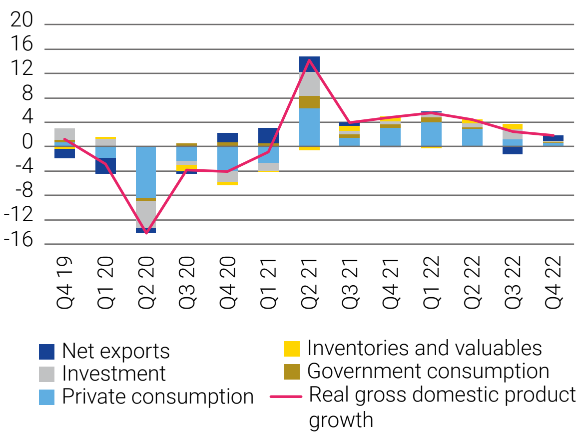


Source: Eurostat

Euro area GDP was resilient in 2022, growing by 3.5%, due to a strong first half of the year as Covid-19 containment measures were lifted (Figure 2). Due to the impact of Russia's war in Ukraine, growth slowed in the second half of the year as a spike in inflation and rising interest rates weighed on private consumption, and external demand weakened (Figure 3). Rising financing costs and elevated uncertainty also hampered private investment. However, this was compensated by some recovery in the transport sector on the back of easing supply constraints and investments under the recovery and resilience plans, while investment activity related to intellectual property transactions from multinationals caused significant volatility. The moderation in aggregate demand was accompanied by lower manufacturing production over the summer, especially in energy-intensive sectors, and reduced construction activity due to higher prices and shortages of raw materials and intermediate inputs. Euro area real GDP decreased slightly in the fourth quarter of 2022 compared to the previous quarter but, despite negative growth, was better than had been expected earlier in 2022. Employment recovered from the lows touched during the pandemic and lent resilience to almost all countries.

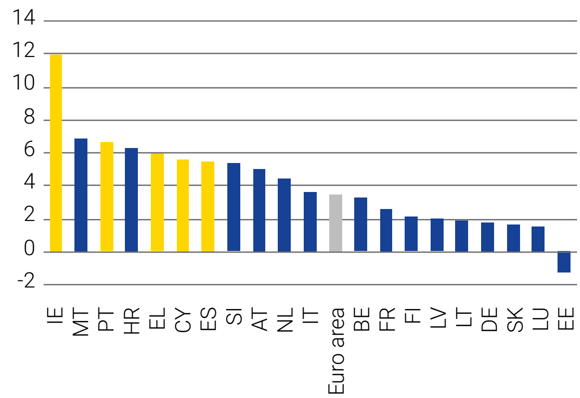
The easing of Covid-19 containment measures benefitted the service sector in early 2022, leading to stronger activity, particularly in member countries with large tourism sectors (Figure 4). Energy supply issues and increased energy prices gradually dampened manufac-

Figure 3
Euro area contributions to real gross domestic product growth
(year-on-year growth in %, contributions in percentage points)



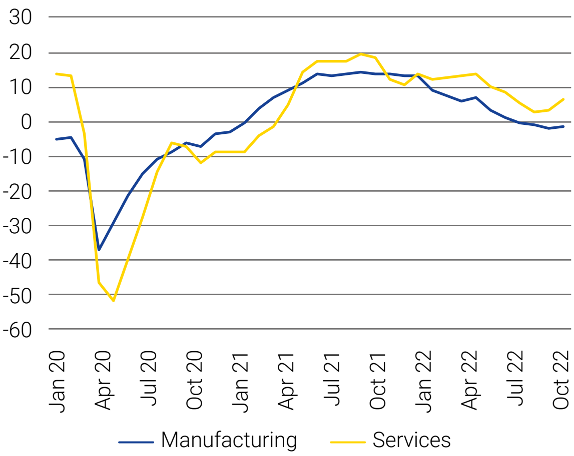
Source: Eurostat

Figure 4
Real gross domestic product growth in 2022
(in %)



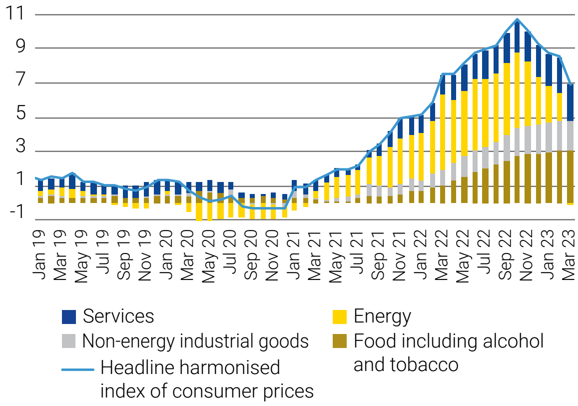
Note: ESM/EFSF former programme countries in yellow.
Source: Ameco, European Commission

Figure 5
Euro area confidence in services and manufacturing
(% balance)



Source: Eurostat

Figure 6
Euro area contributions to harmonised index of consumer price inflation rate
(year-on-year inflation in %, contribution in percentage points)



Source: Eurostat

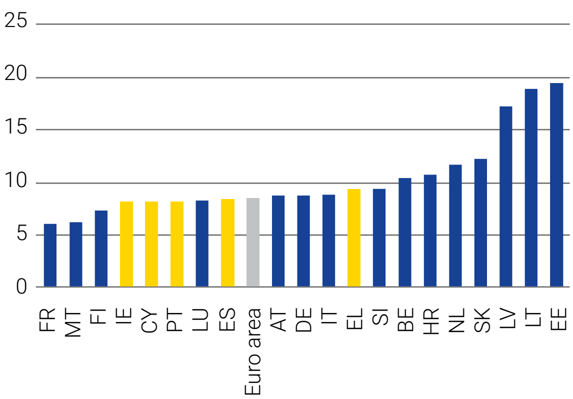
turing activity, particularly in countries heavily reliant on gas imports and manufacturing industries. Global supply-chain impairments did not dissipate fully and weighed on economic activity. Confidence fell accordingly in both sectors in the course of 2022, though it seems to have stabilised at the end of the year (Figure 5).

The reopening of economies around the world, the war in Ukraine, and the resultant energy crisis drove euro area inflation up to 8.4% in 2022, a sharp acceleration from 2.6% in 2021 (Figures 6 and 7). Headline inflation peaked in October at 10.6% and moderated slightly thereafter as energy price increases slowed. Earlier increases in the cost of energy translated into higher core inflation[3] and food prices. In December, core inflation reached a record high of 5.2%. Despite broad inflationary pressures, wage growth in 2022 strengthened but remained contained compared to the surge in inflation. The latest agreements point to higher wage growth, and profit margins have remained fairly resilient, creating the risk of second-round effects and more persistent core inflation.

Continued application of the Stability and Growth Pact's general escape clause and the disbursement of funds from the EU's Next Generation EU recovery package provided euro area governments with space

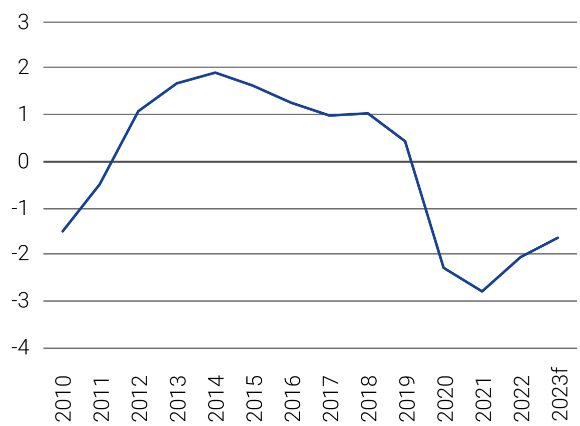
[3] Harmonised index of consumer price inflation excluding energy, food, alcohol, and tobacco.

Figure 7
Harmonised index of consumer price inflation rates in 2022
(in %)



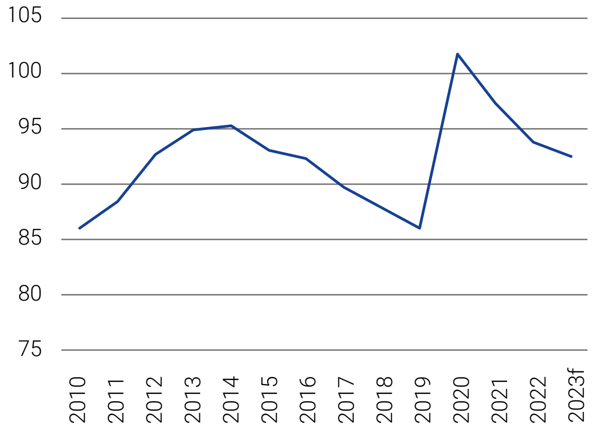
Notes: ESM/EFSF former programme countries in yellow. The chart depicts annual aggregate inflation.
Source: Eurostat

Figure 8
Euro area structural primary balance
(in % of potential GDP)



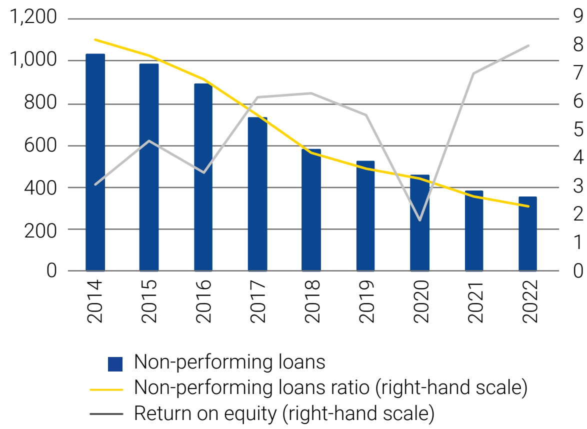
Note: f=forecast.
Source: Autumn 2022 European Commission Economic Forecast

Figure 9
Euro area government debt
(in % of GDP)



Note: f=forecast.
Source: Autumn 2022 European Commission Economic Forecast

Figure 10
Non-performing loans, non-performing loan ratio, and return on equity in the euro area
(left-hand scale in € billion, right-hand scale in %)



Sources: European Banking Authority Risk Dashboard, ESM calculations

to respond in 2022 to the pandemic and energy crisis. The support provided to households and businesses to cope with sharply elevated energy prices partially offset the effect on public budgets from the phasing out of pandemic support measures. In its November 2022 forecast, the European Commission estimated the 2022 net budgetary costs of measures at around 1.2% of GDP. While governments' finances benefitted from windfall revenues due to inflation and better-than-expected growth in the first half of the year, energy support measures weighed on fiscal balances and on efforts to rebuild fiscal buffers (Figures 8 and 9).

Euro area member states continued to benefit from the Next Generation EU package agreed in 2020. In particular, the Recovery and Resilience Facility – the key instrument at the heart of Next Generation EU – is expected to boost euro area economic growth and enhance investments and reforms for the green and digital transition. In spring 2023, the Eurogroup agreed on the main priorities reflecting the European Commission's earlier fiscal policy guidance. In light of the expected deactivation of the general escape clause, the European Commission's guidance provides orientations for Member States' 2024 fiscal policies. At the same time, the European Commission and the EU Member States are working on the redesign of the EU fiscal framework. On the basis of the European Commission's November communication, the Ecofin Council agreed on the main reform elements in March 2023. Agreement on the detailed legislative proposals is expected by the end of 2023.

The euro area financial sector remained resilient in 2022. Banks continued to reduce non-performing loans (NPLs), resulting in the average NPL ratio falling below 2.5% (Figure 10). Following significant growth in mortgage books at the outbreak of the pandemic, 2022 saw a further expansion in credit, mainly driven by loans to non-financial corporations (Figure 11). In the short run, bank profit margins benefitted from the ECB's monetary policy tightening, with return on equity reaching 8% by end-2022. Going forward, rising interest rates and a weak economic outlook may pose downside risks, as the recent turmoil in the banking sector has shown.

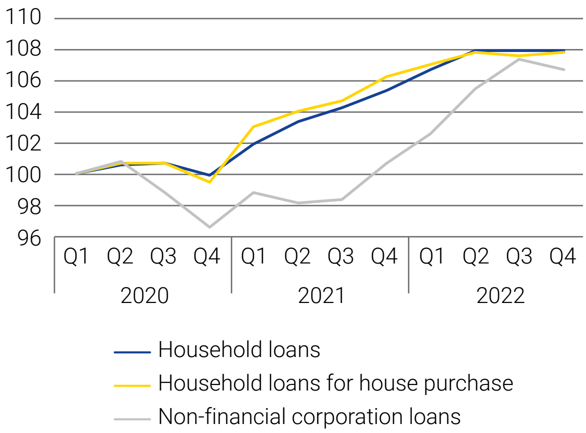
Performance among non-bank financial intermediaries was mixed in 2022. Despite challenging market circumstances and valuation losses on their investments, insurers outperformed their peers due to improvements in their balance sheet position and the prospect of growing returns. Asset managers suffered a significant decline in the value of bonds and stocks, as well as material redemptions by investors. Liquidity strains for financial institutions and corporates, generated by commodity price volatility and turbulence on the UK government bond market in October 2022, provided timely reminders of the risks to financial stability that can stem from this sector.

On global financial markets, reflation dominated throughout 2022. Market-based long-term inflation expectations peaked in April, reaching 3% in the US (10-year breakeven), and 2.5% in the euro area (5-year, 5-year forward inflation swap rate). The US Federal Reserve and the ECB responded with robust monetary policy tightening, and inflation expectations receded to about 2.3% in both economies. Ten-year US Treasury yields rose to almost 4% by end-2022 from 1.5% at end-2021, and the GDP-weighted average euro area government bond yield rose to 3.4% from 0.3%. Equity markets lost value and corporate and emerging market credit spreads widened. Euro area government bond yields and spreads were volatile, reflecting uncertainty about the geopolitical environment, the inflation outlook, and the policy response (Figure 12). Market conditions remained broadly calm on the back of ECB measures to avert financial market fragmentation.

Early 2023 developments

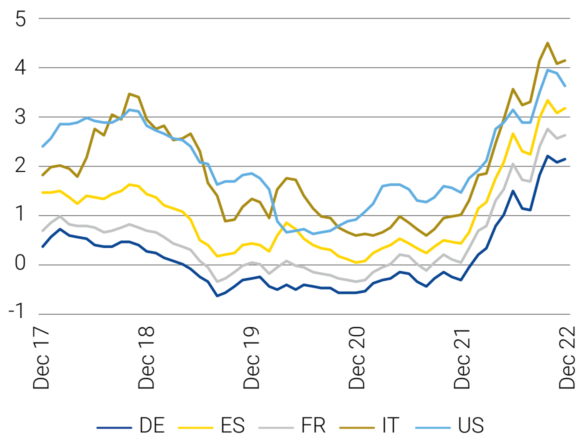
In early 2023, the outlook improved. Growth forecasts were revised upwards, and the most recent inflation data indicate that overall price pressures have started to recede. However, both food and core inflation are still increasing. Financial markets had a calm start to the year, but uncertainty about the growth and inflation outlook persists. The fiscal guidance provided by the Eurogroup in March 2023, together with an ongoing discussion on economic governance, will be instrumental in reducing uncertainty and anchoring expectations beyond 2023. Recent developments in the banking sector underscore the importance of implementing the common backstop and continuing to work on banking union as agreed by the Eurogroup.

Figure 11
Euro area increase in oustanding amounts of loans
(rebased figures, 2020 Q1=100)



Sources: European Banking Authority Risk Dashboard, ESM calculations

Figure 12
10-year government bond yields of the US and selected euro area member states
(in %)



Source: Bloomberg

"Our diverse and committed staff, who have come together for a shared purpose, are key to our success in supporting the euro area yesterday, today, and tomorrow. Synchronising the relationship between these talented individuals, lean processes, and innovative systems ensures our organisational readiness to respond quickly and appropriately whenever needed."

Sofie De Beule-Roloff
Chief Operating Officer

Former programme country experiences

Ireland

The Irish economy showed strong growth in 2022, buoyed by resilient exports and domestic demand. Fiscal policy remained supportive. Outperforming fiscal revenues allowed the Irish government to achieve a surplus, despite increasing expenditure. Irish banks' financial positions remained sound and their profitability improved over the course of the year.

A surge in exports helped propel real GDP growth to 12%, aided by private consumption. Inflation reached 8.1% year-on-year in December 2022, largely driven by energy prices and a continuation of food price hikes resulting from the war in Ukraine. Domestic economic activity, stripped of the effects of multinational firms, increased by 8.2%. The unemployment rate reaching a long-term low of 4.5% by the end of the year, thanks to a post-pandemic rebound and a dip in immigration triggered by the Covid-19 crisis, combined with an all-time high vacancy rate, resulted in labour market tightness, especially for highly skilled workers. This tightness contributed to inflation.

The 2022 fiscal position shows a surplus. Revenue again exceeded expectations in most tax categories, including corporate taxes, where a substantial and potentially volatile portion arises from a small number of multinationals. The overall fiscal performance gave the government room to provide significant help to households and firms to help them cope with rising prices. Strong GDP growth and the fiscal surplus shrank gross debt to 44.7% of GDP. Nonetheless, alternative scaling metrics based on modified gross national income (GNI*), which isolate and remove the effects on GDP of the highly mobile activities of multinational companies, show Ireland's debt level – while declining – remained high at 83.3% in 2022.

Buoyant tax revenue allowed the National Treasury Management Agency to issue less new debt than planned. While the debt interest burden lightened further in 2022, the cost of new debt increased in step with interest rates. Fitch and Moody's upgraded Ireland's sovereign credit ratings.

Irish retail banks' capital and liquidity positions remained strong and well above regulatory minimums. Asset quality further improved during 2022, though risks may arise from the small and medium-sized enterprises portfolio, particularly in sectors hit hard by Covid-19 restrictions. Bank profitability returned to pre-pandemic levels and banks are expected to benefit from the rising interest rate environment, although this may also drive some deterioration in asset quality in vulnerable sectors. Bank operating costs also remained higher than European peers. The sector's deposit base remained large and stable.

The economy is forecast to grow by 4.9% in 2023, and headline inflation to decline to 4.4% mainly thanks to easing energy price pressures. The Irish economy is exposed to the risks of sustained high inflation, and to weakening foreign demand, due to its reliance on exports. In banks, asset quality in the small and medium-sized enterprises portfolio may deteriorate, and a shift toward lending by less regulated non-bank financial institutions will require continued scrutiny. Non-bank financial institutions are active lenders in the mortgage and small and medium-sized enterprise markets as they offer targeted products at generally lower interest rates. However, their competitive advantage was reduced as interest rates increased, affecting their funding costs in the wholesale market, thus reversing the trend in lending. Ireland retains the capacity to meet all its debt service obligations due to the EFSF over the coming 12 months. The cash buffer is projected to remain at adequate levels, sufficient to withstand a variety of negative shocks. The ESM assesses the risks of market stress to be low over the short term. Over the medium to long term, Ireland faces low risks to the sustainability of public debt affecting its repayment capacity, even if costs of ageing remain a challenge.

Greece

Greece staged a robust economic performance in 2022, withstanding the economic fallout from the war in Ukraine. Employment, tourism, and fiscal revenue all recorded strong gains. This created space for one of the largest fiscal support packages among euro area countries for households and firms to help them cope with high energy prices. Public debt fell precipitously, and Greece exited the European Commission's enhanced surveillance in August, testimony to the country's substantial economic progress in recent years.

Economic activity grew 5.9% in 2022, putting Greece back on its pre-pandemic economic trajectory. The economy benefitted from a strong labour market, the return of tourism activity to pre-pandemic levels, and the impetus generated by Greece's recovery and resilience plan – which benefitted from significant financial support from the Next Generation EU package.

The primary balance jumped to 0.1% of GDP, significantly improved from the -4.7% of GDP of 2021. Tax revenue grew at a record pace, giving the government room to provide extensive financial support to households and firms. This fiscal relief helped shield the economy from the effects of high inflation. Growth and inflation generated a 23-percentage-point drop in the debt-to-GDP ratio to 171% of GDP, the second largest single-year reduction in the public-debt ratio ever recorded in euro area history. However, the current account deteriorated further from an already weak starting point.

Financing conditions tightened over the year amid ECB interest rate increases, resulting in average sovereign spreads for Greece climbing to 230 basis points, more than double the 2021 average. However, investors were reassured by the ECB's commitment to counter unwarranted and disorderly market dynamics that pose a serious threat to the transmission of monetary policy across the euro area, via the introduction of the Transmission Protection Instrument. Effective interest rates on Greece's public debt are not very sensitive to market developments, reflecting ultra-long maturities and low fixed interest rates. The country's cash buffer remained comfortable.

Bank solvency indicators remained adequate. With the help of the government-supported asset protection scheme and strong investor demand, banks reduced their aggregate NPL ratio to 8.7%. Still, the NPL ratio of Greek banks is substantially above the euro area average and most of the legacy NPLs now outside the banks' balance sheets remain unrestructured, underscoring the need for effective implementation of the insolvency framework. Bank lending activity was cautious, with private-sector credit expanding by 5%, driven by loans to non-financial corporations.

Greece exited enhanced surveillance in August 2022 after substantial progress in implementing reform commitments across a wide range of areas. Notable achievements included operationalising the new insolvency framework, developing a divestment strategy for the Hellenic Financial Stability Fund, modernising labour legislation, and introducing a new legislative framework for state-owned enterprises.

In view of 2022 results, the euro area member states agreed on the disbursement of the final two tranches of policy-contingent debt relief measures and the reduction to zero of the step-up margin on certain EFSF loans from 2023 onwards. The total undiscounted value of all the medium-term debt relief measures since 2018 amounts to €11.5 billion.

Greece's 2023 macroeconomic outlook is predicated on an expected slowdown. Growth is forecast at 1.2% in 2023, and inflation at an elevated rate of 4.5%. Greece retains the capacity to repay all obligations due to the ESM/EFSF over the coming 12 months. The cash buffer is projected to remain comfortable. Greece's sovereign ratings improved as major rating agencies moved the country closer to investment grade. The ESM's analysis of market distress points to low risks of market stress over the short term. Yet over a longer horizon, Greece faces challenges to the sustainability of public debt and its repayment capacity that stem from the still high level of public and external debt, large and widening external deficits, weak productivity growth, and banking sector vulnerabilities. To mitigate these challenges, Greece is firmly committed to fiscal prudence and rigorous implementation of structural reforms under its recovery and resilience plan.

Spain

Spain's economy posted robust growth in 2022 and the labour market performed strongly. The country faced new challenges associated with the war in Ukraine despite the low direct exposure to energy market disruptions. Government policies mitigated the impact of high energy prices. The Spanish Treasury maintained favourable market access in an environment of rising interest rates. The profitability of Spanish banks improved, although it will be weakened in 2023 by the implementation of an exceptional levy on financial institutions intended to fund measures to ease the effects of the increased cost of living.

Spain's economic growth held steady in 2022, driven by the strong rebound in tourism. Real GDP expanded by around 5.5% in 2022, unchanged from the previous year. The recovery from the pandemic crisis was particularly visible in exports of services and to a minor extent in private consumption. Unemployment eased to around 13% in December 2022 from 13.3% a year earlier, and employment increased by over 2% in 2022. Inflation, having spiked to beyond 10% in mid-2022, gradually slowed towards the end of the year, primarily due to a retreat in energy prices. Core inflation rose throughout the year, reaching 6.7% year-on-year in December 2022.

Public finances improved gradually, but public debt remained high. The budget deficit narrowed to 4.8% of GDP in 2022 from about 7% in 2021, also on the back of strong tax revenues. Public debt declined following strong nominal GDP growth and prudent fiscal policy but remained above 110% of GDP in 2022. The government has made progress in implementing the reform agenda associated with Next Generation EU funds. In addition, agreement has been reached on the reform of the pension system, increasing revenue for the social security system. Maintaining this momentum is crucial to boosting growth and strengthening the fiscal position.

Spain retained favourable market access. Its 10-year yield stood above 3% in December 2022 amid the brisk rise in inflation and anticipated monetary policy response. The average maturity of Spain's debt remains relatively long, around eight years, limiting its sensitivity to market interest rate movements. In March 2022, S&P withdrew its negative outlook on Spain's A rating.

After weathering well the distress resulting from the pandemic, Spanish banks' profitability and capitalisation have improved over the course of last year, although they remain under pressure in the medium term. NPL ratios converged to relatively low levels at the end of 2022 (below 4%), although the pace of the fall in the NPL ratio slowed during the year, as public support measures introduced during the pandemic began to expire. Some loans with public guarantees have started to become non-performing, although the share of such loans remains small. Spain took majority ownership and full control of the asset management company Sareb, which was created to manage troubled assets. This followed the reclassification of the entity into the public accounts and accounted for three percentage points of the debt-to-GDP ratio in 2020.

The Spanish economy is projected to grow by around 1.5% in 2023, though at a markedly slower pace than in 2022, yet above the EU average in a context of global deceleration. Inflation is set to gradually ease in 2023. However, persistent price pressures, especially from core inflation and tighter global financial conditions, are among the risks that could adversely affect the economic outlook. Nevertheless, the Spanish Treasury can service its debt, including loan payments to the ESM. ESM analysis suggests low short-term market stress risks. Medium- to long-term challenges to public debt sustainability and its repayment capacity may emerge due to the high debt level, age-related public spending, low productivity, and investment gaps. The successful implementation of the mix of reforms and investments from the Next Generation EU package is crucial to enhancing growth and the economy's ability to respond to future shocks. Measures supporting higher productivity growth and credible fiscal plans in the medium term will be crucial to maintaining investor confidence.

Cyprus

Cyprus' economy recorded strong growth in 2022, partially due to the smaller-than-expected negative impact of the war in Ukraine. The government budget balance moved into a surplus as pandemic-related fiscal support ended and energy-related spending remained limited. Sovereign financing conditions deteriorated throughout the year. In the banking sector, profitability improved but NPL reduction slowed. Risks to debt sustainability and repayment capacity were contained, despite a weakened macroeconomic outlook. The government's continued reform efforts, supported by the implementation of the recovery and resilience plan, could raise the country's growth potential and further promote financial stability.

Cyprus' GDP grew swiftly in 2022, confirming the resilience of the economy despite the challenging economic and geopolitical environment. Real economic activity grew by 5.6% in 2022, above the euro area average and largely driven by robust domestic demand, in particular private consumption, and to a lesser extent external demand. The economic fallout from Russia's invasion of Ukraine and subsequent sanctions imposed on Russia had less impact than expected. Exposure to Russian energy imports was limited, while the tourism sector coped well with the loss of Russian tourists and saw demand approaching pre-pandemic levels. The labour market remained strong overall, with an unemployment rate of 7.4% in December 2022. Cyprus received its first disbursement of €85 million under the EU's Recovery and Resilience Facility in December.

Strong economic activity, prudent fiscal policy, and the end of pandemic-related support contributed to turning the 2021 fiscal deficit into a surplus of 2.1% of GDP in 2022. Higher revenues and contained energy-related expenditure pushed the primary surplus to 3.6% in 2022. In the high-inflation environment, this contributed to a sharp fall in the public debt-to-GDP ratio to 86.5% in 2022. Cyprus' credit ratings improved in 2022 due to better-than-expected economic and fiscal results, proven resilience to external shocks, support from the Recovery and Resilience Facility, and the positive medium-term economic outlook. All major rating agencies assigned an investment grade to Cyprus, except for Moody's, which nonetheless changed its outlook to positive.

Still, Cyprus faced a more challenging market environment in 2022. Yields increased throughout the year as inflation rose and monetary policy started to tighten financing conditions.

Cyprus' banking sector remained resilient. The direct negative effects of Russia's invasion of Ukraine were primarily concentrated on one Cypriot bank, which decided to voluntarily phase out its banking business following the impact of geopolitical risks on its operations. The volume of outstanding NPLs stabilised in 2022, following considerable reductions over the past few years. In the medium term, the excess liquidity in the system and a further slowdown in NPL workouts could limit banks' overall profitability gains. The government launched several policy initiatives to address high private sector indebtedness and avoid the build-up of new NPLs. This has become even more urgent in the current high interest rate environment.

Cyprus' economic activity is forecast to lose momentum and grow by 1.6% in 2023, while headline inflation is expected to decline to 4%. Downside risks relate to persistently high inflation weighing on domestic demand, accompanied by a further tightening of financial conditions. The ESM's assessment of market distress indicates that Cyprus would retain the capacity to repay all obligations due to the ESM over the coming 12 months. An adequate cash buffer helps limit the risk of short-term market stress. Over the medium to long term, Cyprus faces moderate risks to the sustainability of public debt and its repayment capacity. To mitigate these risks, Cyprus has committed to fiscal prudence and implementing the investments and reforms foreseen under its recovery and resilience plan. Macro-critical reform priorities include facilitating the transition to a diversified, green, and digital economy, as well as further improving the operational and legal environment for non-bank financial institutions (credit acquirers and servicers). The recurring challenges to and the partial suspensions of the foreclosure framework continue to pose risks to further NPL reduction.

Portugal

Strong economic growth in Portugal was driven by private consumption and exports in 2022, despite a sharp rise in inflation and tightening financial conditions. The general government deficit narrowed, supported by a rebound in revenues and lower-than-budgeted public investment. Public debt continued declining as a percentage of GDP. Market access conditions remained favourable, despite a rise in sovereign bond yields. Portuguese banks' profitability rebounded as interest rates increased and credit quality improved.

Real GDP expanded by 6.7% in 2022, propelled by private consumption and exports of services, in particular tourism. Inflation soared due to the war in Ukraine, with core inflation and food and energy prices rising sharply. The labour market remained resilient, and the unemployment rate remained low. By the end of the year, the European Commission endorsed a positive preliminary assessment of Portugal's second payment request under the country's recovery and resilience plan, confirming the implementation of agreed milestones and targets.

The 2022 general government deficit narrowed to 0.4% of GDP, from 2.9% of GDP in 2021. Strong economic growth and inflation, as well as a robust labour market, lifted revenues, and the winding down of Covid-related fiscal support curbed expenditure. These developments created space for comprehensive measures to mitigate the impact of high energy prices. Public debt decreased to 113.9% of GDP in 2022 from 125.4% of GDP in 2021.

Portugal retained good market access in 2022. The Portuguese Treasury's gross bond issuance reached about €12 billion, while net issuance was negative. The outstanding stock of tradable state debt declined by nearly €0.7 billion. The Eurosystem purchased around €3.6 billion in Portuguese public debt in 2022.

Major rating agencies retained their investment grade credit ratings on Portugal and there were some positive rating changes over the course of 2022. These reflected the country's strong commitment to prudent fiscal policy, robust growth and labour market outcomes, receding credit vulnerabilities, and marked resilience to external shocks.

The banking sector's profitability continued its recovery in 2022, as asset quality remained resilient and further cost-reduction initiatives bore fruit. Loans formerly under moratoria resumed regular payments for the most part, helping banks to reduce loan losses. However, overall capital ratio levels declined as rapidly rising interest rates triggered mark-to-market losses and dividend distribution was resumed. As a result, and taking into account the more adverse economic environment, banks became more risk-averse and tightened conditions for loans to non-financial corporations and households.

The European Commission foresees a significant moderation in Portugal's GDP growth in 2023 to 1%, and headline inflation easing to 5.4%. This reflects some stabilisation after the post-pandemic rebound and a loss of purchasing power due to inflation. Downside risks stem from persistently high inflation, tightening financial conditions, and weakening external demand. A high share of variable rate mortgages also puts additional pressure on the financial health of households. Portugal retains the capacity to repay all obligations due to the EFSF over the coming 12 months. The ESM's analysis of market distress suggests low risks of market stress over the short term. Over the medium to long term, risks to public debt sustainability and its repayment capacity remain significant due to low labour productivity and insufficient investment. However, Portugal has committed to prudent fiscal policy and to swiftly implementing investments and reforms under its recovery and resilience plan, which could mitigate risks to repayment capacity.

Pandemic crisis support signals ESM's commitment to its mission

In December 2022, the ESM's Pandemic Crisis Support (PCS) expired, marking the end of a €240-billion credit line that provided one of the European safety nets established to counter the unprecedented socio-economic consequences of the pandemic. Despite the significant challenges and risks posed by the Covid-19 crisis, the ESM was able to mobilise its staff expertise in record time to contribute to the comprehensive European response and provide this vital stabilising support. Marking a key milestone in the history of the ESM, the PCS is testament to the agility of the institution and its ability to respond quickly to crises in the service of its mandate.

While no requests were made to draw on the PCS to cover healthcare costs during the pandemic, the establishment of the credit line played a vital signalling role. By providing substantial reassurance in the earliest phases of the pandemic, the PCS contributed to calming markets and bolstering confidence during the gravest challenge faced by the euro area since the sovereign debt crisis a decade earlier.

The spread of Covid-19 in 2020 triggered the need for a coordinated EU response to protect the economic, financial, and social integrity of the union. In spring 2020, European finance ministers decided to establish three important safety nets for workers, businesses, and sovereigns. This included an agreement for the ESM to create the temporary PCS facility to support national financing of healthcare related costs stemming from the Covid-19 crisis.

The PCS's €240-billion envelope was made available to allow each ESM Member to have access and potentially draw upon a low-interest loan worth 2% of their GDP with a maturity of up to 10 years. PCS assistance was subject to conditionality, as with all ESM instruments, but was adapted to the unique nature of the crisis. Based on the framework of an existing instrument (the Enhanced Conditions Credit Line), the only requirement to access the PCS was to commit to using the funds to support domestic financing of direct and indirect healthcare, cure, and prevention-related costs of the Covid-19 crisis. To allow the investor community to allocate funds to support the social needs of euro area member states, the ESM established a social bond issuance framework.

As one part of the overall EU pandemic response, the PCS coincided with the ECB monetary response to the crisis and the prevailing historically low interest rates and contributed to reinforcing the resilience of the euro area in a time of crisis. By establishing the instrument quickly and confirming that all ESM Members were equally eligible to draw upon it, the PCS gave global investors confidence that euro area member states would have immediate access to funding if needed. The effect of announcing dedicated ESM support, along with the wider European safety nets elaborated during the pandemic, undoubtedly contributed to preventing any sudden interruptions of cross-border financial flows[4] – a view confirmed by market participants, including credit rating agencies.[5]

Thanks to the creation of the ESM during the sovereign debt crisis, the euro area was better prepared to safeguard its financial stability. Its rapid mobilisation and ability to produce a tailored response to a unique challenge testifies to the ESM's commitment to pursue its mandate in the face of unprecedented shocks and considerable uncertainty.

4 Cimadomo, J., Hauptmeier, S., Holm-Hadulla, F., & Renault, T. (2022). Risk sharing in the euro area: a focus on the public channel and the COVID-19 pandemic. Economic Bulletin Articles, 7.

5 For more information see: April 2020 – Moody's – Credit Opinion: Update after creation of "Pandemic Crisis Support" credit line; October 2021, European Commission communication "The EU economy after Covid-19: implications for economic governance".


European Stability Mechanism
esm
European Financial Stability Facility
efsf

02

ESM activities

Asset and Liability Management and Financial Structuring

ESM assesses balance sheet impacts of the new interest rate environment and changes in the asset and liability structure.

ESM performs in-depth analyses on the interest rate risk hedging programme and the collateral volatility buffers.

ESM continuously seeks efficiency gains through the automation of key operational processes and integrated tools.

The ESM measures, monitors, and manages liquidity, currency, and interest rate mismatches between assets and liabilities that may arise from the execution of the ESM and EFSF mandates. Financial structuring, interest rate modelling, simulation, and scenario analysis covering all balance sheet risks are other major parts of the team's work.

Over the course of the year, the ESM performed impact simulations of both changes to the balance sheet's structure and changes in the interest rate environment, projecting the cost of lending for beneficiary Member States. It also contributed to ensuring readiness of the instruments within the ESM's financial toolkit and their operational framework.

Beyond this work, the ESM oversaw the full ESM/EFSF balance sheet, including the analysis and management of liquidity, currency, and interest rate risks. Increased automation in operational processes such as simulations, analyses and reporting have generated efficiency gains. To create synergies in managing liquidity, the activities of the Asset and Liability Management and Financial Structuring division and the Funding and Investor Relations division were fully coordinated.

"The ESM has proven itself the embodiment of solidarity within the euro area and an example of what can be achieved within the existing legal framework. I am confident we will see the continuance of that vision, with the ESM legal team as guide and pathfinder."

David Eatough
General Counsel

Lending

Greece repays all its International Monetary Fund debt with a third early repayment of €1.9 billion and prepays €2.7 billion to the Greek Loan Facility lenders after waivers from the ESM and EFSF.

Spain makes its first scheduled principal repayment to the ESM in December, delivering €3.6 billion.

The ESM and EFSF agreed on 28 March to waive prepayments by Greece that would have been triggered by its planned early repayments of €1.9 billion to the International Monetary Fund and €2.7 billion to the Greek Loan Facility. The waiver decisions by the ESM and EFSF Boards of Directors considered the advantages for Greece's debt management.

This was Greece's third and last early repayment to the International Monetary Fund, which was initially scheduled for 2022–2024. The Greek Loan Facility prepayment was the first of its kind, corresponding to the principal repayment originally scheduled for 2023. This facility was part of the first financial support programme for Greece and consists of bilateral loans from 14 fellow euro area countries. In June 2022, Greece also repaid €14.3 million to the ESM ahead of schedule as part of a contractual obligation associated with the dividend of the Hellenic Corporation of Assets and Participations.

On 12 December, Spain repaid €3.6 billion to the ESM, representing its first scheduled repayment of indirect bank recapitalisation loans. Between 2014 and 2018, Spain had made nine early repayments of these loans, amounting to €17.6 billion. To date, Spain has made €21.3 billion in voluntary and scheduled principal repayments.

The total loan portfolio managed by the Lending team amounted to €260.9 billion at the end of 2022.

Funding and Investor Relations

ESM/EFSF issues €27.5 billion in bonds with regular new lines and taps of existing bonds.

ESM adapts timing and currency composition of its funding programme to the market environment.

ESM adjusts bill programme due to reduced liquidity needs and phases out 12-month bill line.

Derivatives and Market Intelligence division helps launch central clearing project at Eurex.

ESM investor relations team returns to normal activity with 28 events over the year.

Flexibility and liquidity drive bond strategy

The combined ESM and EFSF funding programme reached €27.5 billion in 2022, split into €8 billion for the ESM and €19.5 billion for the EFSF (Figure 13).

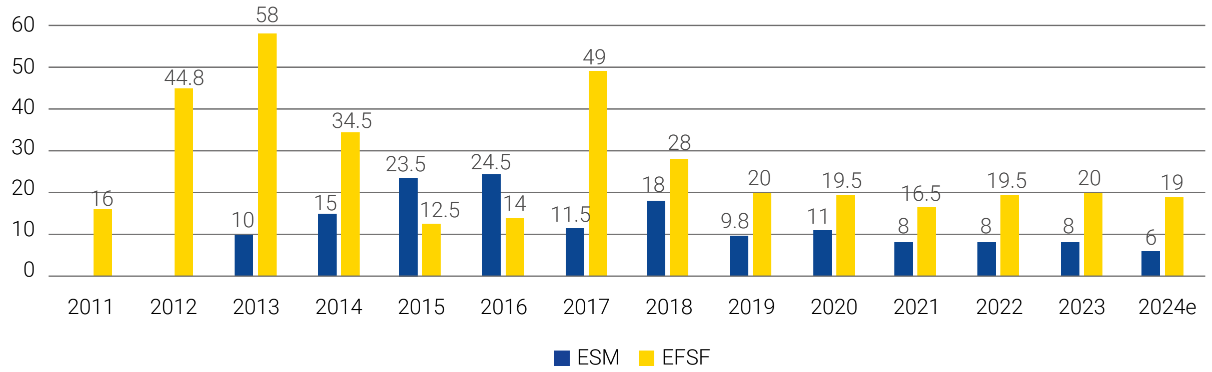
The ESM focused its 2022 funding strategy on the issuance of medium-sized benchmark transactions of €2-3 billion across the curve. As in previous years, the ESM favoured tapping outstanding lines to increase their liquidity and the frequency of issuance.

This year, the timing and currency composition of syndications differed compared to 2021. The funding programme ended exceptionally early in 2022 with the last ESM transaction on 17 October, two weeks after the final EFSF transaction. The ESM issued no dollar-denominated bonds in 2022, focusing instead on euros to take advantage of increased demand for short-dated euro bonds stemming from higher European interest rates. This has allowed the ESM to tap into that demand several times at attractive rates for beneficiary Member States.

The ESM ceased prior announcement of issuance windows, as part of a new communication strategy for 2022, allowing greater flexibility in timing when going to market. This approach has reaped benefits for the ESM and EFSF as issuers as well as for their investors, allowing the institutions to respond to market demand and avoid unduly heavy supply or volatile trading sessions during executions.

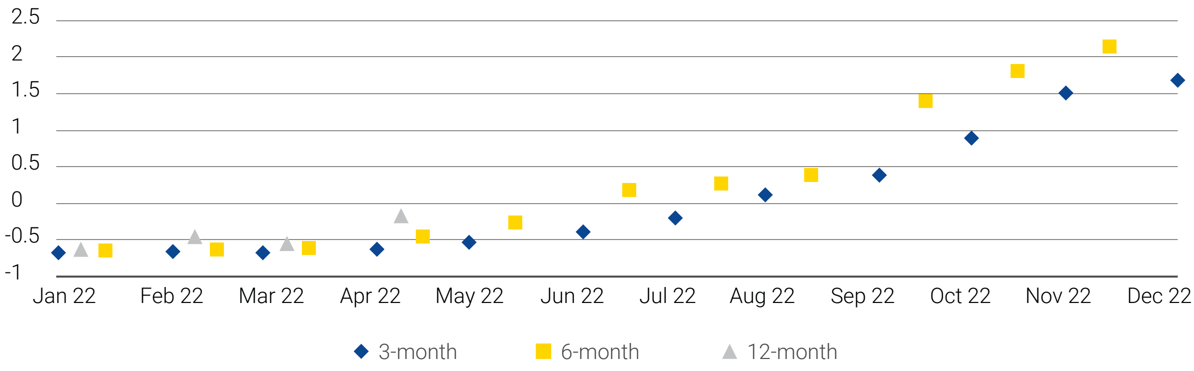
In addition, the ESM and EFSF adjusted their trade execution strategy to account for market volatility. In 2022, the ESM began executing more intraday transactions compared to its customary two-day transactions, meaning announcing and pricing on the same day instead of announcing one day before. Intraday transactions carry significantly less exposure to market volatility and price moves. The ESM still used two-day executions in 2022 when it aided market participants in the price discovery process, such as following unexpected changes to economic data or shifts in the official interest rate outlook.

Figure 13
ESM/EFSF bond issuance
(in € billion)



Note: 2024e = estimate of 2024.
Source: ESM

Figure 14
Average yield of ESM bills



Note: Yields at pricing of auction.
Source: ESM

Bill programme streamlined

The 2022 ESM bill programme continued to attract investors, providing the ESM with liquidity and flexibility.

This year's bill auctions were all well over-subscribed, with a total volume of €30.6 billion, comprising €14.5 billion in 3-month bills, €11.9 billion in 6-month bills, and €4.1 billion in 12-month bills. That the lowest volume was for the 12-month line reflects a bill programme strategy change. In April 2022, after two years of existence, the ESM announced the phasing out of the 12-month bill line due to lower liquidity needs, thereby reducing the supply of bills to two lines per month.

The average yield of the bill programme evolved over 2022 in line with market developments, with a gradual increase observed from a negative yield environment in the first half of the year to positive territory since July.

The highest yield was 2.45% on a 6-month bill issued in November, and the lowest yield was -0.68%, on a 3-month bill in March (Figure 14).

Launch of central derivatives clearing project at Eurex

In November 2022, the ESM launched a project to become a clearing member for derivatives at the European exchange for cleared derivatives.

This project followed a detailed preliminary analysis based on a recommendation from the Board Risk Committee. In June 2022, the committee approved the establishment of direct membership at Eurex in Frankfurt for central clearing counterparty services for interest rate swap transactions.

The central clearing counterparty implementation project is aligned with the European Commission's strategy of pushing for strengthening EU-based clearing since Brexit removed London clearing systems from EU oversight.

This membership model is in line with peer institutions such as KfW and the German Debt Management Office, both of which also clear directly through Eurex.

The Derivatives and Market Intelligence team contributed to the project on front-office topics to support the project team in delivering central clearing counterparty access in the coming years.

A return to meeting investors in person

The ESM increased physical meetings and events in 2022 due to a return to normality following the Covid-19 pandemic. However, some events and meetings with investors remained virtual or in hybrid mode, as these have proven very efficient methods of keeping in touch.

The ESM organised and participated in a total of 28 roadshows and conferences, 15 bilateral calls with investors, and five high-level meetings. In March, the ESM organised its first roadshow outside Europe since the onset of Covid-related restrictions, gradually increasing the number of physical meetings with investors. Over the course of the year, ESM Investor Relations staff met a total of 110 investors across events, roadshows, calls, and conferences.

June marked the third edition of the Capital Markets Seminar, co-organised with the European Investment Bank and the European Commission and held in a hybrid format to allow for on-site investor attendance for the first time since the pandemic.

The second half of the year saw a full return to normal activity, with the ESM closing the year with a European tour, organising roundtable discussions and bilateral meetings with high-level investors in Paris, London, Frankfurt, and Amsterdam.

In 2022, 46 new investors joined the ESM's investor base bringing the total number to over 1,700. The breakdown maintains a wide and well-diversified composition, both geographically and by investor type.

Stable funding outlook for 2023

The 2023 combined funding target for the ESM and EFSF is €28 billion, comprising €8 billion for the ESM and €20 billion for the EFSF.

Table 1
ESM scores top ratings by all agencies

	S&P	Fitch	Moody's	DBRS Morningstar	Scope
Long-term rating	AAA	AAA	Aaa	AAA	AAA
Short-term rating	A-1+	F1+	P-1	R-1 (high)	S-1+
Rating outlook	Stable	Stable	Stable	Stable	Stable

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

Investment and Treasury

ESM investment portfolios incur losses in 2022 amid global yields increase.

ESM reduces interest risk to mitigate impact of rising rates on its paid-in capital.

ESM implements ESG scoring of its paid-in capital, highlighting its ESG performance.

Investment portfolios incur losses as global yields increase

The ESM's paid-in capital stood at €80.5 billion at the end of 2022 and will total €81.5 billion in 2035 when all instalments from ESM Members will have been received, including those from Croatia, which joined the ESM on 22 March 2023. The capital is invested in three tranches with different investment horizons, liquidity objectives, and financial valuation methods. The short-term and medium/long-term tranches, whose assets are marked-to-market, are invested with an average maturity below two years. The hold-to-maturity tranche, valued on an amortised cost basis, is invested in securities with maturity at purchase usually beyond five years. Since inception, €3.2 billion accumulated in reserves are invested in the short-term tranche, as is a newly created €0.1-billion building fund corresponding to the approved budget for the construction of a new ESM headquarters.

In 2022, inflation soared well above central banks' expectations as the global economy rebounded from the 2020 pandemic crisis and Russia invaded Ukraine, causing major increases in energy and commodities prices. To bring down inflation, central banks started raising interest rates and adjusting asset purchases and other measures to reduce their balance sheets. Uncertainty about the scale of monetary policy tightening needed to contain inflation, and the impact on economic activity, led to a highly volatile market environment.

In this market context, the ESM's marked-to-market portfolios recorded a return of -4.52%. This result was driven by the steep increase in European bond yields across maturities, with 10-year yields on the ESM's eligible assets finishing the year 300 basis points higher on average, leading to sharply lower asset valuations. Negative remuneration on cash until September also contributed to the negative return.

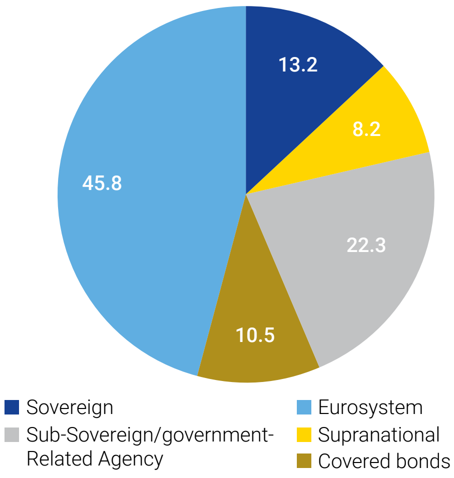
The paid-in capital recorded an accounting loss of €257.2 million for the year, including a loss of €277.0 million for the short-term and medium/long-term tranches. These losses were mainly caused by securities sales at lower prices compared to their carrying value, as part of the regular adjustment of the portfolio exposure, and were partially offset by a positive result on derivatives operations, used to manage interest rate and currency risks.

Unlike in previous years, only part of negative interest paid on paid-in capital cash deposits with the Eurosystem in 2021 was compensated. The ESM received €15.2 million from the Netherlands, while France, Germany, and Italy withheld their potential compensation of €175.8 million, as some conditions were not met. The accounting loss will reduce the €1.543 billion accumulated profits on the investment portfolio since inception, including €915.4 million in extraordinary income from negative interest compensation received up to the end of 2022 for the period 2017–2021. From January to September 2022 the ESM continued to incur negative interest charges, which may be compensated by some participating shareholders, subject to the compensation mechanism conditions. From mid-September onwards, as yields turned positive, the compensation mechanism is no longer applicable.

ESM reduces its interest risk to shield paid-in capital from rising rates

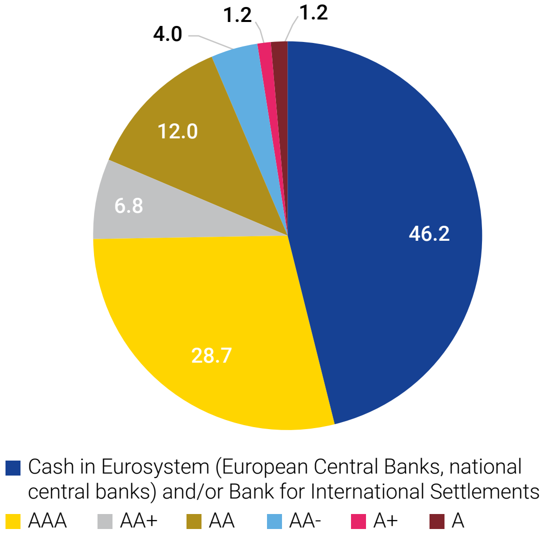
To mitigate the impact of rising yields and high volatility on its marked-to-market portfolios, the ESM significantly reduced the interest rate sensitivity of the paid-in capital portfolio and undertook an exceptional review of its strategic benchmarks. As part of that process, the ESM sold assets and used interest rate derivatives that offered liquidity and consistent pricing across the yield curve when market conditions were difficult. The ESM increased its allocation to short maturities, as yields rose into positive territory, and continued to keep a large allocation to cash deposited in the Eurosystem, remunerated at €STR (the euro short-term benchmark rate). Cash represented close to half of the paid-in capital by year-end.

Figure 15
Asset class distribution of investments
(in %)



Source: ESM

Figure 16
Ratings distribution of investments
(in %)



Source: ESM

The ESM's portfolio composition fluctuated, while remaining diversified across the eligible asset classes and currencies. With rising yields, the ESM reduced its allocation to supranational securities and increased slightly its sovereign exposure. As a result, the share of paid-in capital held in government-related agency, sub-sovereign, supranational, and covered bonds decreased by two percentage points to 41% (Figure 15). The ESM also increased its allocation to euro denominated assets, which offered more favourable risk-adjusted returns. Hence, the size of non-euro denominated assets, hedged into euros, was lowered by €7.5 billion to reach a €3.9 billion equivalent. Holdings in Japanese yen and the US dollar assets shrank the most. As in previous years, the credit quality of the paid-in capital remains very high, with 97.7% (Figure 16) held with Eurosystem central banks or invested in assets rated AA- or higher.

In a year dominated by risk-reduction measures, the annual performance of the marked-to-market portfolios was 23 basis points below the strategic benchmarks, reducing the portfolio outperformance since inception to 14 basis points per year from 19 basis points in 2021. The benchmarks, which are endorsed by the Board Risk Committee, consist of indices of AAA/AA-rated euro area government and supranational bonds spread across maturities ranging from zero to 10 years.

In April 2022, the ESM also decided to pause the building up of its hold-to-maturity tranche, as the economic and interest rate outlook seemed excessively unpredictable to continue increasing long-term exposure. This portfolio is invested in diversified, highly rated eligible securities with maturities of seven to 20 years. As of year-end 2022, the portfolio stood at €11.1 billion and generated an annual accounting profit of €19.4 million.

Issuer-based ESG scoring of paid-in capital

Since signing the UN-backed Principles for Responsible Investment in 2020, the ESM has focused on developing an issuer-based ESG scoring for its paid-in capital investments. In 2022, the ESM selected Moody's Vigeo Eiris as its ESG data provider, chosen for the quality of its scoring methodology, its broad coverage of the ESM investment universe, its focus on ESG performance, and its balanced approach across ESG criteria.

Applying the ESG scores to the paid-in capital, the ESM obtained an ESG weighted average score of 73 out of 100 at the end of 2022, corresponding to Moody's advanced category, defined for scores between 60 and 100. When analysing the score per asset class, it appears that, on average, ESM holdings of sovereign and supranational bonds are also in the advanced category, with scores of 79 and 71 respectively, while financials – representing covered bond issuers – are on average scored at 54, associated with the Moody's robust category, for scores from 50 and 60. To compute these scores, the ESM applies the sovereign score on the aggregate exposure to all sovereign, sub-sovereign, and agency issuers from a given country. This approach ensures consistent methodology for all public sector issuers, despite significant differences in the domestic public financing systems across countries. It also overcomes some data limitations, as not all eligible issuers are scored by the data provider. The ESM aims to provide more granular information about the ESG quality of its assets, as it further develops its monitoring tools. For more information, see ESM enhances its responsible investment approach by monitoring the ESG score of its paid-in capital.

In parallel, the ESM continued investing in use-of-proceeds bonds. At the end of 2022, the ESM held €4.5 billion of these, of which €4.3 billion were compliant with the International Capital Market Association principles and guidelines, split nearly equally between social, green, and sustainability bonds. The remaining €0.2 billion are "pandemic bonds", whose proceeds financed part of the response to the Covid-19 crisis. The size of these investments had fallen from €8.2 billion at end-2021 due to the reduction in the market risk exposure of the portfolio and increased investments at short maturities, where the supply of use-of-proceeds bonds is generally scarce.

ESM enhances responsible investment by monitoring ESG score of its paid-in capital

The ESM chooses a holistic ESG approach aligned with standard European principles

As part of its commitment to responsible investment, the ESM has introduced ESG-quality scoring of its €80.5 billion paid-in capital.

To capture the ESG impact of ESM investments and remain in line with the values and principles endorsed by the EU, the ESM uses a holistic scoring approach compatible with its investment mandate:

- All paid-in capital assets except cash holdings are scored.
- Scores are applied at the issuer level to measure the ESG quality of the portfolio.
- Scores are based on the assessment of all three ESG pillars, associated with relatively equal weights.
- Scores are based on a broad range of indicators.
- The scoring methodology is aligned with accepted European principles, including the UN-defined Sustainable Development Goals endorsed by the EU.

The ESM focuses on the impact of issuers on ESG priorities

To define its own responsible investment approach, the ESM examines the ESG impact of each issuer's overall activity.[6] The ESM also invests in dedicated use-of-proceeds bonds directly tied to ESG efforts and regularly publishes information on its holdings. Additionally, ESM credit risk assessments increasingly integrate ESG-risk considerations.[7]

To compute the scores for the paid-in capital, the ESM chose the ESG data provider Moody's Vigeo Eiris. This agency applies a compatible scoring approach using a balanced weighting of all three ESG dimensions to measure the degree to which companies take into account and manage material ESG factors.[8]

For sovereigns, the score captures a wide range of factors. In the environmental category, the scores consider the transition to green growth, climate change mitigation, the reduction of carbon emissions, the protection of water resources, and biodiversity.

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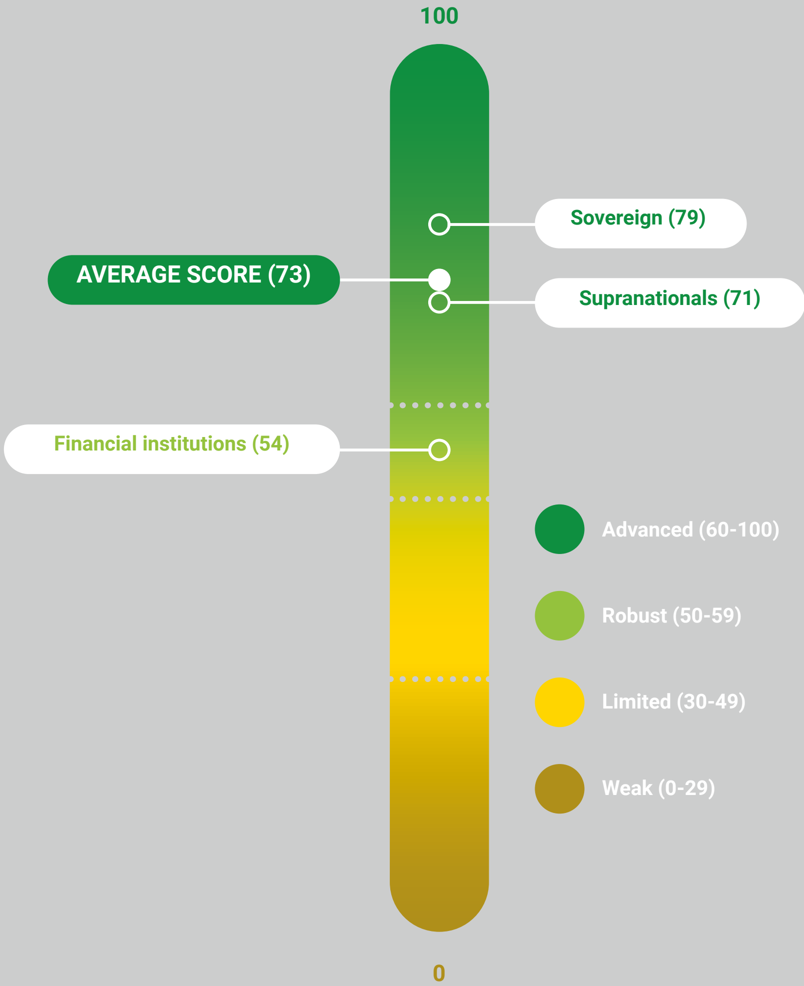
6 The ESG impact focuses on the impact of an issuer on an ESG theme. For example, an issuer activity could have a negative impact on CO_2 emissions, biodiversity, or waste management.
7 ESG risk is the risk that an issuer may face in its activity because of developments related to ESG themes. For example, an increasing risk of flood or fires could negatively affect the credit risk of an issuer.
8 ESG Assessment Methodology Executive Summary, Moody's Vigeo Eiris, August 2020.

Paid-in capital ESG score per issuer type



In the social category, it considers the promotion of education, health, social protection, gender equality, and safety and security. For governance, it considers the respect of human rights, democracy and stability, labour rights, and the prevention of discrimination. Similar elements are assessed for supranational issuers and financial institutions, with some differences in how factors are weighted and a stronger focus on business practices.

The ESM opts for a transparent and consistent scoring methodology

The ESM uses Moody's Vigeo Eiris as a data provider to compute the scores with the aim of being transparent in its approach, consistent over different jurisdictions, and as comprehensive as possible, while still respecting data confidentiality on ESM holdings and individual ESG scores. In this context:

- **The ESM groups its assets into three major asset types, representative of the ESM investment universe: sovereign, supranational, and financial institutions.** As the data provider's methodology is adapted to each asset class, using different sub-domains and weights, this breakdown enables a representative score per asset type. The ESM also computes a weighted average score for the entire paid-in capital.

- **The ESM aims to use the score from the provider directly, with some limited exceptions.** The ESM applies the available issuer scores for supranational and financial institutions for covered bond exposures. For sovereigns and government-related issuers (agencies and sub-sovereigns), the ESM has decided to group them into a single category to ensure a high degree of consistency across countries. This prevents significant differences in methods of domestic public financing from distorting the scores, for example between France, where more than 80% of public sector bonds are issued by the central government, and Germany, where the equivalent figure is about 50%. This approach also ensures a high coverage of more than 80% of assets in 2022, overcoming some data limitations on smaller local issuers.

- **The ESM uses proxies in the rare cases that large issuers are not covered by the external provider.** For supranationals with multiple entities like the World Bank Group or the Inter-American Development Bank, the ESM uses the parent score. Pending the availability of a score for the EU as a supranational issuer, the ESM computes the score using the EU Member States' weighted average sovereign scores.

Scores highlight high ESG-quality of ESM assets and set the stage for further responsible investment

Moody's Vigeo Eiris scores issuers on a 0 to 100 scale and groups them by broad categories to facilitate the assessment of the issuer's ESG impact: advanced (above 60), robust (between 50 and 60), limited (between 30 and 50), and weak (below 30).

Using Moody's methodology, the ESM calculates the scores for its end-of-year holdings per asset type and for the entire paid-in capital. As of end-2022, the total portfolio's ESG score stands at 73, with scores for supranationals of 71 and sovereigns of 79, while financial institutions scored slightly lower at 54. These results demonstrate that ESM assets, on average, score in the advanced category along with the supranational and sovereign holdings, while financials are robust.

These scores help the ESM obtain an accurate picture of an issuer's contribution to the overall ESG impact. Given the constraints on ESM investment activities, in respect of credit quality and liquidity, the scores represent a good achievement. Future scoring will provide a dynamic picture of the ESG profile of the ESM portfolio and help identify potential issues for action.

"The daunting challenge of building a modern international financial institution from scratch while successfully tackling a severe crisis affecting millions of citizens was made possible through the motivation, dedication, and perseverance of exceptional colleagues, who have contributed to this endeavour over the last decade."

Nicola Giammarioli
Secretary General

Risk Management

- ESM reacts promptly to new risks and unprecedented volatility.
- ESM enhances cybersecurity and information security measures.
- ESM finalises and reviews the risk framework for the Single Resolution Fund backstop.
- ESM introduces climate-related risks within its risk management framework.
- ESM improves risk monitoring and automation.
- ESM values knowledge sharing.

ESM assesses impact of volatile environment on its operations

The ESM remained vigilant to ongoing and evolving risks throughout the year. The post-Covid supply shock, the Russian invasion of Ukraine, and the subsequent energy crisis shaped an environment of high uncertainty and high inflation. The ESM reacted promptly by performing assessments on the direct and indirect impact of the war in Ukraine on ESM funding operations and investment exposures, identifying issuers and counterparties potentially more exposed, as well as the consequences of financial sanctions.

The ESM closely monitored risk developments in financial markets and reported them to the relevant risk committees in a timely manner. Given the unprecedented volatility, the rate hikes by major central banks and subsequent sharp rises in interest rates triggered an internal review of the investment portfolio strategy and a reduction of the overall sensitivity to interest rates. The ESM assessed direct and indirect exposure to the real estate sector, to address concerns about interest rates denting residential mortgage performance, and commercial mortgages suffering from the economic downturn and the diminished post-pandemic demand for office space.

In 2022, credit rating agencies issued negative outlooks on some of the issuers and derivative counterparties to which the ESM was exposed, particularly in the second, third, and fourth quarters, due to the consequences of the war in Ukraine. However, rating actions remained balanced in net terms across the ESM's portfolio, confirming its robust asset quality in accordance with the ESM's investment guidelines and risk policies.

Focus on information security and cyber risks amid geopolitical tensions

Increased geopolitical tensions caused by the war in Ukraine have increased the risk of large-scale cyber-attacks. The Risk Management division's dedicated information security function provides a second line of defence overview of cybersecurity and information security risk and incident prevention, identification, and response.

Risk Management continued to collaborate closely with the information technology (IT) division to enhance protection against cyber-attacks, in line with industry-standard practices.

Finalising the risk framework for the Single Resolution Fund backstop

The Risk Management division contributed to developing the ESM's operational readiness for its broadened mandate. The division reviewed ESM risk policies to prepare the risk management and governance procedures for the common backstop for the Single Resolution Fund.

Risk Management completed the validation of the model developed in collaboration with the Single Resolution Board to assess the repayment capacity of the Single Resolution Fund. The validation, performed with the support of an external opinion, focused on three pillars for its assessment: conceptual soundness, implementation, and use of outputs. The final validation report confirmed the theoretical soundness of the model and its technical implementation.

Climate-related risks built into management framework

The ESM has increased awareness and concern for the environment and climate-related risks, such as those arising from changes in weather and climate that impact economies (physical risks) and those stemming from transitioning economies reliant on fossil fuels to low-carbon economies (transition risks). Accordingly, the ESM is embedding climate-related risks into its risk management framework, thereby factoring in physical and transition risks and the impact of climate risk drivers into existing risk categories.

Risk Management has created a plan to develop tools and risk metrics and to formalise the identification and monitoring of climate-related risks in its internal policies and procedures. The ESM will continue to follow best practices and external guidelines to update and further enhance its methodologies.

ESM improves risk monitoring and automation

The ESM further improved risk monitoring capabilities over the course of 2022. Risk Management automated the reconciliation of data used for reporting purposes to ensure the quality and accuracy of the information; expanded the set of alerts and blocking rules in the payment control system; and completed the rollout of an IT solution that streamlined the processes of collecting, storing, analysing, and reporting information relevant to the ESM's operational risk framework.

ESM values knowledge sharing

In 2022, the ESM continued to exchange best practices with other international financial institutions and peer organisations, including with the Bank for International Settlements, the European Commission, the Council of Europe Development Bank, the European Investment Bank, and the Nordic Investment Bank. Risk Management organised and participated in conferences, meetings, and workshops to share expertise on various risk topics.

Risk Management also collaborated internally with other divisions, supporting various initiatives with technical expertise, and strengthening the ESM's risk culture.

ESG at the ESM

ESM increases institutional efforts towards integrating ESG and climate change considerations.

Fourth carbon footprint report shows decline in emissions from ESM activities.

ESM establishes strategic steering group to drive and coordinate cross-divisional ESG initiatives.

In February 2022, ESM joins the Network of Central Banks and Supervisors for Greening the Financial System as an observer.

Environmental efforts

The ESM monitors, measures, and reports on the environmental impact arising from its internal operations, publishing its fourth carbon footprint report in August 2022. This reporting exercise guides the design of measures to monitor and enhance its environmental practices and to reduce the use of natural resources and energy. For the fourth year in a row, the ESM registered a decline in emissions, resulting in part from a reduced office presence due to the pandemic and in part from emissions-cutting measures in day-to-day operations. The ESM remains committed to further strengthening its environmental practices. For a detailed overview of the environmental measures implemented so far, please read the 2021 carbon footprint report.

Social endeavours

The ESM ensures that its activities are conducted in accordance with the highest standards of integrity, operating in line with its Code of Conduct and its eight internal values. In 2021, the ESM updated its Code of Conduct, expanding its ESG commitment to providing a safe work environment in compliance with the ESM's values of respect and accountability. The ESM has independent bodies in place to assess and address any breaches, including an administrative tribunal. For further information, please visit the ESM compliance and ethics webpage.

Governance strategies

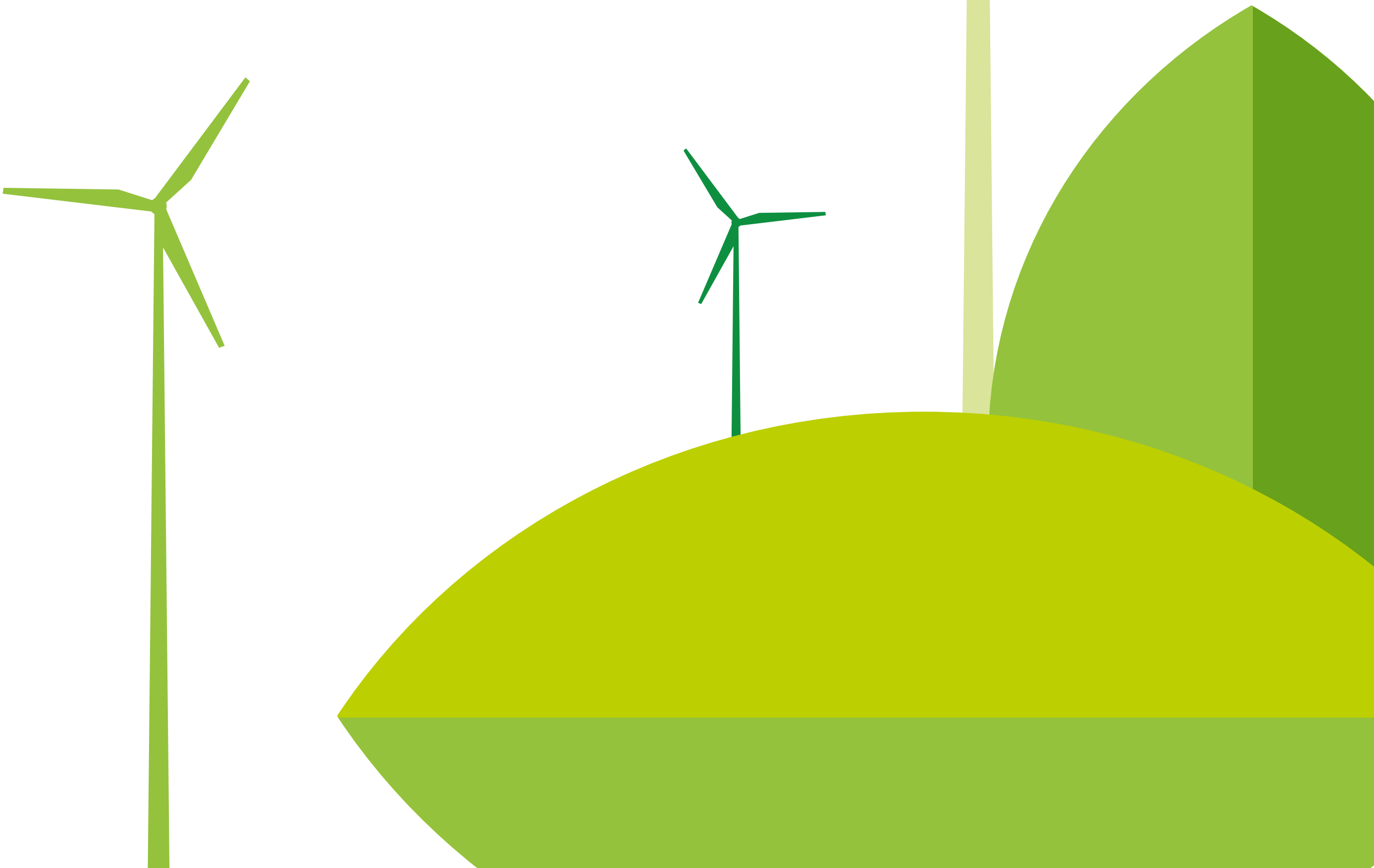
The ESM has a robust governance framework in place to ensure accountability and transparency towards its shareholders and other stakeholders. In response to the increasing interest in ESG practices, dialogue, and information, the ESM began reporting on its ESG activities in 2018 and has since significantly broadened its approach to each of the three ESG pillars.

For 2022, the ESM identified ESG and climate change as one of its strategic priorities. Given the elevated importance of ESG topics and the accelerated pace of new, relevant initiatives in 2022, the ESM established an internal ESG Strategic Steering Group. This high-level group serves to coordinate and implement numerous cross-divisional ESG initiatives. The group includes members of the Management Board and provides guidance to the working-level ESG liaison group established in 2018.

During 2022, as part of its commitment to the UN-backed Principles for Responsible Investment, the ESM procured the services of an ESG-scoring data provider to further embed ESG criteria into its investment practices. For more information, see Investment and Treasury.

To better inform, shape, and enhance ESG-related thought leadership and objectives in 2022, the ESM continued to engage actively with credit- and ESG-rating agencies, as well as with investors, peer institutions, and policymakers.

As part of its efforts to contribute to the low-carbon transition in Europe and globally, the ESM joined the Network of Central Banks and Supervisors for Greening the Financial System as an observer. As part of this network, the ESM contributes to the development and promotion of best practices aimed at strengthening the global response to managing risks related to climate change. The ESM is also an observer in the European Commission's Platform on Sustainable Finance and a member of the International Capital Market Association Social Bond Working Group.



"Rapidly establishing the ESM's high standing among international investors has been a unique and exciting experience and an opportunity to lead highly skilled teams through deep crises and volatile markets. I am proud to see the ESM's strength and how ready it stands to face future challenges."

Christophe Frankel
Deputy Managing Director and Chief Risk Officer

Transparency and accountability

The ESM takes various measures to ensure its stakeholders and the public have a good understanding of its mandate and work. The ESM regularly assesses the information that could be made publicly available and proactively publishes a wide range of policies, legal documents, and decisions by governing bodies regarding its operations and the implementation of its mandate on its transparency webpage.

In 2022, the ESM Managing Director and senior staff participated in various conferences, seminars, and academic gatherings. In addition, ESM senior staff engaged in a continuous dialogue with national and international media, resulting in television appearances and interviews with Bloomberg, CNBC, and leading European newspapers.

Over 2022, the ESM published 14 blog posts featuring regular columns by senior ESM managers and staff on various ESM and euro area topics, some of which were reported on by international media.

As an institution with a public mandate, the ESM has accountability embedded in its governance structure and activities. The ESM's Board of Governors, its highest decision-making body, consists of the euro area finance ministers, who represent the Members' democratically elected governments. Furthermore, national parliamentary procedures, required by some Members before the Board of Governors or Board of Directors approves decisions, make the ESM indirectly accountable to some national parliaments.

The ESM's accountability framework is also underpinned by the Board of Auditors' extensive audit oversight. The Board of Auditors' annual report to the Board of Governors, accompanied by ESM management comments issued in response to the report, are made available to the national parliaments and supreme audit institutions of the ESM Members, the European Parliament, the European Court of Auditors, and to the public via the ESM website. In 2022, the ESM also exchanged views with the European Court of Auditors in the context of its audit of the EU's financial landscape.

03

Framework and organisation

Governance

WWW Visit our website for more information on our governance.

ESM shareholders

The ESM shareholders are the 20 euro area member states, which are also referred to as ESM Members. ESM Members have contributed to the ESM's authorised capital based on their respective shares of the EU's total population and GDP. The authorised capital amounts to €708.5 billion and is divided into paid-in and callable capital. Since the membership of Croatia on 22 March 2023, the paid-in capital stands at €80.97 billion.

Croatia joins the ESM

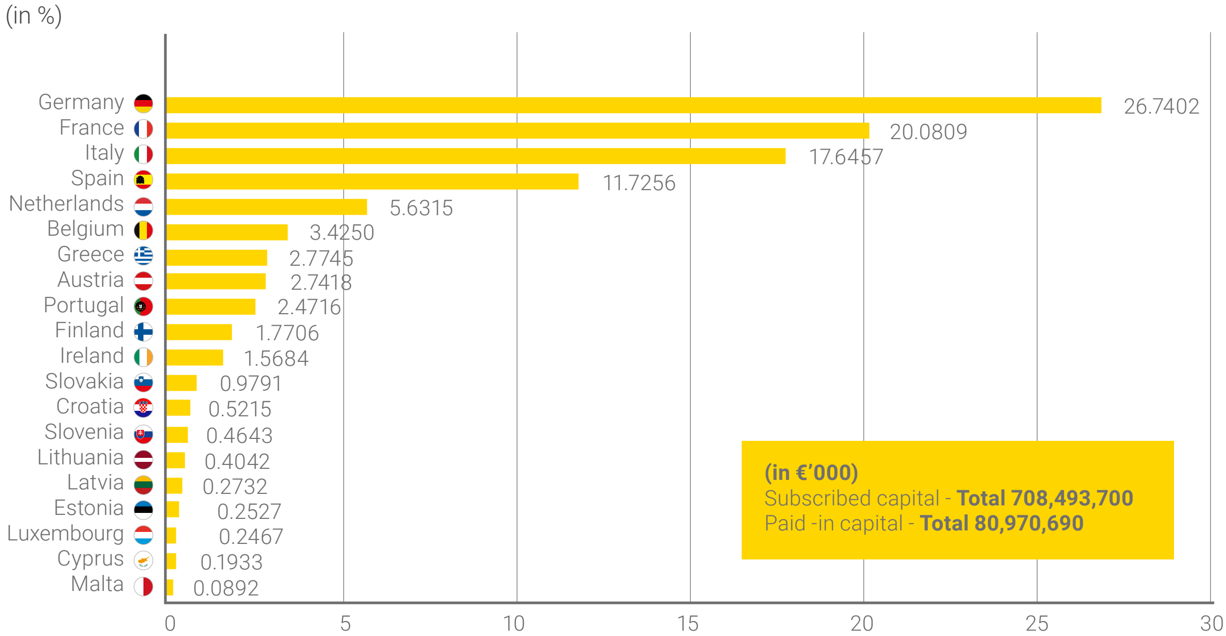
Croatia joined the euro area on 1 January 2023, following approval by the Council of the European Union in July 2022. Under the ESM Treaty, all euro area member states should become ESM Members. As such, following the Board of Governors' approval of Croatia's application to join the ESM on 5 December 2022, Croatia became the 20th ESM Member on 22 March 2023. Croatia qualifies for a temporary correction, and its capital contribution key was set at 0.5215%. This resulted in a capital subscription of €3.695 billion including €422.3 million in paid-in capital. Croatia will make the payments of paid-in capital in five annual instalments of €84.46 million, with the first instalment paid to the ESM on 30 March 2023. Once the temporary correction comes to an end on 1 January 2035, Croatia will deposit the remaining €233.01 million.

Shareholder engagement

The 10th Shareholders' Day took place on 9 and 10 November 2022 at the ESM premises in Luxembourg. The event brought together representatives from ESM Members, the European Commission, and the ECB. The event offered participants the opportunity to present and discuss various topics related to or relevant for the ESM, thereby encouraging future exchanges and helping solidify relations between the ESM and its Members. This year, sessions focused on fiscal stabilisation, the green transition, and climate risks. Speakers included ESM staff, academics, and representatives from partner institutions.

The ESM also participated in various forums over the year at which its shareholders are represented, such as the Eurogroup, the Eurogroup Working Group, and the Task Force on Coordinated Action.

Table 2
ESM contribution key
(in %)



Notes: As of 24 April 2023. In line with Article 42 of the ESM Treaty, ESM Members with GDP per capita of less than 75% of the EU average in the year immediately preceding their ESM accession benefit from a temporary correction mechanism. During this period, the initial capital subscription of the ESM Member benefitting from the correction is lower, thus leading temporarily to a lower paid-in capital contribution. Once this period ends, the ESM Member must deposit the remaining amount. Most recently, Estonia's temporary correction period expired on 1 January 2023, and Estonia deposited the remaining paid-in capital contribution. Latvia, Lithuania, and Croatia are currently benefitting from temporary corrections, the last of which expires on 1 January 2035.

Source: ESM

"The ESM has safeguarded the integrity of the euro area, proven itself a success, and earned trust with the help of its tremendously dedicated team and skilled leadership. The new ESM Treaty will strengthen the institution and allow it to continue to fulfil its role as a crisis resolution mechanism."

Rolf Strauch
Chief Economist

Board of Governors

Annual Meeting of the Board of Governors

The Board of Governors is the highest decision-making body of the ESM and is made up of government representatives with responsibility for finance from each of the ESM shareholders. The Board of Governors meets at least once a year and whenever the affairs of the ESM so require, resulting in five meetings and two votes without meeting in 2022.

On 16 June 2022, the Board of Governors held its 10th annual meeting in Luxembourg, where then Managing Director Klaus Regling presented a review of the ESM's operations for the year, key achievements over the past 10 years, and contributions to maintaining financial stability. He also provided an update on the state of play of the preparation for the implementation of the ESM's enhanced mandate and the project to build a new ESM headquarters. The Board of Governors approved the 2021 Annual Report and thanked outgoing Managing Director Regling for his outstanding work in developing the ESM through its first decade.

The Chairperson of the Board of Auditors addressed the Governors on the ESM 2021 financial statements and the Board of Auditors' annual report. In addition, the external auditor presented its report in respect of the audit of the ESM 2021 financial statements.

Members of the Board of Governors

Chairperson of the Board of Governors
Paschal Donohoe

Ireland

Eurogroup President since 9 July 2020,
Minister for Public Expenditure,
National Development Plan Delivery and Reform

Vincent Van Peteghem

Belgium

Deputy Prime Minister and
Minister of Finance

Christian Lindner

Germany

Federal Minister of Finance

Mart Võrklaev

Estonia

Minister of Finance

Michael McGrath

Ireland

Minister of Finance

Christos Staikouras

Greece

Minister of Finance

Nadia Calviño

Spain

First Vice-President of the Government,
Minister of Economic Affairs
and Digital Transformation

Bruno Le Maire

France

Minister of Economy, Finance, and
Industrial and Digital Sovereignty

Marko Primorac

Croatia

Minister of Finance

Giancarlo Giorgetti
Italy
Minister of Economy and Finance

Constantinos Petrides
Cyprus
Minister of Finance

Arvils Ašeradens
Latvia
Minister of Finance

Gintarė Skaistė
Lithuania
Minister of Finance

Yuriko Backes
Luxembourg
Minister of Finance

Clyde Caruana
Malta
Minister for Finance and Employment

Sigrid Kaag
Netherlands
Deputy Prime Minister and Minister of Finance

Magnus Brunner
Austria
Federal Minister of Finance

Fernando Medina
Portugal
Minister of Finance

Klemen Boštjančič
Slovenia
Minister of Finance

Eduard Heger
Slovakia
Prime Minister, Minister of Finance

Annika Saarikko
Finland
Minister of Finance

Board of Directors

The Board of Directors consists of representatives from each of the ESM Members and makes decisions as provided for in the ESM Treaty and By-Laws or as delegated by the Board of Governors. The Board of Directors is supported by the Board Risk Committee and the Budget Review and Compensation Committee.

The Board of Directors meets whenever the affairs of the ESM so require, resulting in seven meetings in 2022. The Board Risk Committee and the Budget Review and Compensation Committee meet quarterly and additionally when required.

Members of the Board of Directors

Pierre Gramegna
Chair of the Meetings of the Board of Directors, ESM Managing Director

Steven Costers
Belgium
Counsellor General

Heiko Thoms
Germany
State Secretary

Märten Ross
Estonia
Deputy Secretary General for Financial Policy and External Relations

Gary Tobin
Ireland
Assistant Secretary General, International and EU Division

Michael Arghyrou
Greece
Chairman of the Council of Economic Advisors

Carlos Cuerpo
Spain
Secretary General of Treasury and International Financing

Emmanuel Moulin
France
Director General of the Treasury

Stipe Župan
Croatia
State Secretary

Riccardo Barbieri Hermitte
Italy
Director General of the Treasury

George Panteli
Cyprus
Permanent Secretary

Līga Kļaviņa
Latvia
Deputy State Secretary

Mindaugas Liutvinskas
Lithuania
Vice-Minister

Nicolas Jost
Luxembourg
Deputy Secretary General

Paul Zahra
Malta
Permanent Secretary

Christiaan Rebergen
Netherlands
Treasurer-General

Harald Waiglein
Austria
Director General for Economic Policy, Financial Markets, and Customs Duties

João Nuno Mendes
Portugal
Secretary of State for Finance

Katja Lautar
Slovenia
Director General, Economic and Fiscal Policy Directorate

Peter Paluš
Slovakia
Head of Financial Unit at Permanent Representation of Slovakia to the EU

Leena Mörttinen
Finland
Permanent Under-Secretary

Board of Auditors

The Board of Auditors is an independent oversight body of the ESM that inspects the ESM accounts, conducts audits on the regularity, compliance, performance, and risk management of the ESM, and monitors its internal and external audit processes and results.

In line with Article 24 of the By-Laws, two members are appointed upon the proposal of the Chairperson of the Board of Governors, two members upon nomination by the supreme audit institutions of the ESM Members based on a system of rotation, and one member upon nomination by the European Court of Auditors, each for a non-renewable term of three years. In April 2022, upon the proposal of the Chairperson of the Board of Governors, Lucia Kašiarová was appointed as a member of the Board of Auditors to replace Tommaso Fabi, whose term had come to an end. In October 2022, Giovanni Coppola was also appointed as a new member upon nomination by the Italian supreme audit institution, replacing Ilias Dimitriadis. In December 2022, Helga Berger was appointed upon nomination by the European Court of Auditors, replacing Baudilio Tomé Muguruza. Ms Berger was elected as the Board of Auditors' Chairperson for a one-year renewable term, as of 17 January 2023.

In 2022, the Board of Auditors held eight meetings during which ESM management and senior staff provided updates on ESM activities, the decisions of the ESM governing bodies, and other relevant issues and developments. The Board of Auditors met regularly with the internal audit function and monitored and reviewed the work of the external auditor. Following a review of the external auditor's working papers, the Board of Auditors issued relevant recommendations that ESM management committed to address. In addition, the Board of Auditors met with the Chairperson of the Board Risk Committee and with the Board of Directors. Furthermore, the Chairperson of the Board of Auditors at the time, Baudilio Tomé Muguruza, met with the Chairperson of the Board of Governors and attended the Annual Meeting of the Board of Governors to present and discuss the audit work and reports issued by the Board of Auditors, namely its report on the ESM financial statements and its annual report to the Board of Governors.

In 2022, the Board of Auditors decided to audit the ESM's procurement procedures and contracts with third parties with the support of subject matter experts from the Audit Office of the Republic of Cyprus. The audit is expected to be finalised within the first half of 2023. Furthermore, an audit of ESM's investment strategy with the support of subject matter experts from the German Federal Court of Auditors is scheduled to begin in October 2023. In fulfilling its role, the Board of Auditors reviewed the ESM 2022 financial statements and the working papers of the external auditor.

Members of the Board of Auditors

Helga Berger

Member since 17 December 2022

Chairperson since 17 January 2023

Appointed upon nomination by the European Court of Auditors

Akis Kikas

Member since 8 October 2021

Vice-Chairperson since 20 October 2022

Appointed upon nomination of the Audit Office of the Republic of Cyprus

Jochen Wenz

Member since 8 October 2021

Appointed upon the proposal of the Chairperson of the Board of Governors

Lucia Kašiarová

Member since 25 April 2022

Appointed upon the proposal of the Chairperson of the Board of Governors

Giovanni Coppola

Member since 8 October 2022

Appointed upon nomination of the Italian Court of Auditors

Internal control framework

The ESM internal control framework is embedded in the ESM's daily operations and reflects the nature and complexity of ESM activities and their inherent risks. It is underpinned by the three lines governance model established by the Board of Directors and is aligned with the principles of the Basel Committee's Framework for Internal Control Systems in Banking Organisations.[9] The three lines of defence comprise management and operational controls, risk management and compliance functions, and an internal audit function.

The Managing Director, under the direction of the Board of Directors, is responsible for the maintenance of the framework. Assisted by the Management Board, the Managing Director sets a strong tone at the top and oversees internal controls across all areas of the ESM.

Each year, the Managing Director issues a management report on ESM internal controls to the Board of Directors, via the Board Risk Committee and to the Board of Auditors, with a copy extended to the ESM external auditor. The management report on internal controls as of 31 December 2022 does not indicate material or significant internal control weaknesses.

ESM internal controls include management oversight and control culture, risk recognition and assessment, availability of information relevant to decision-making, processes for monitoring and correcting deficiencies at organisational and business process level, as well as IT general and application controls.

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

ENTITY-LEVEL CONTROLS

Include management oversight and control culture, risk recognition and assessment, availability of information relevant to decision-making, and processes for monitoring and correcting deficiencies.

PROCESS-LEVEL CONTROLS

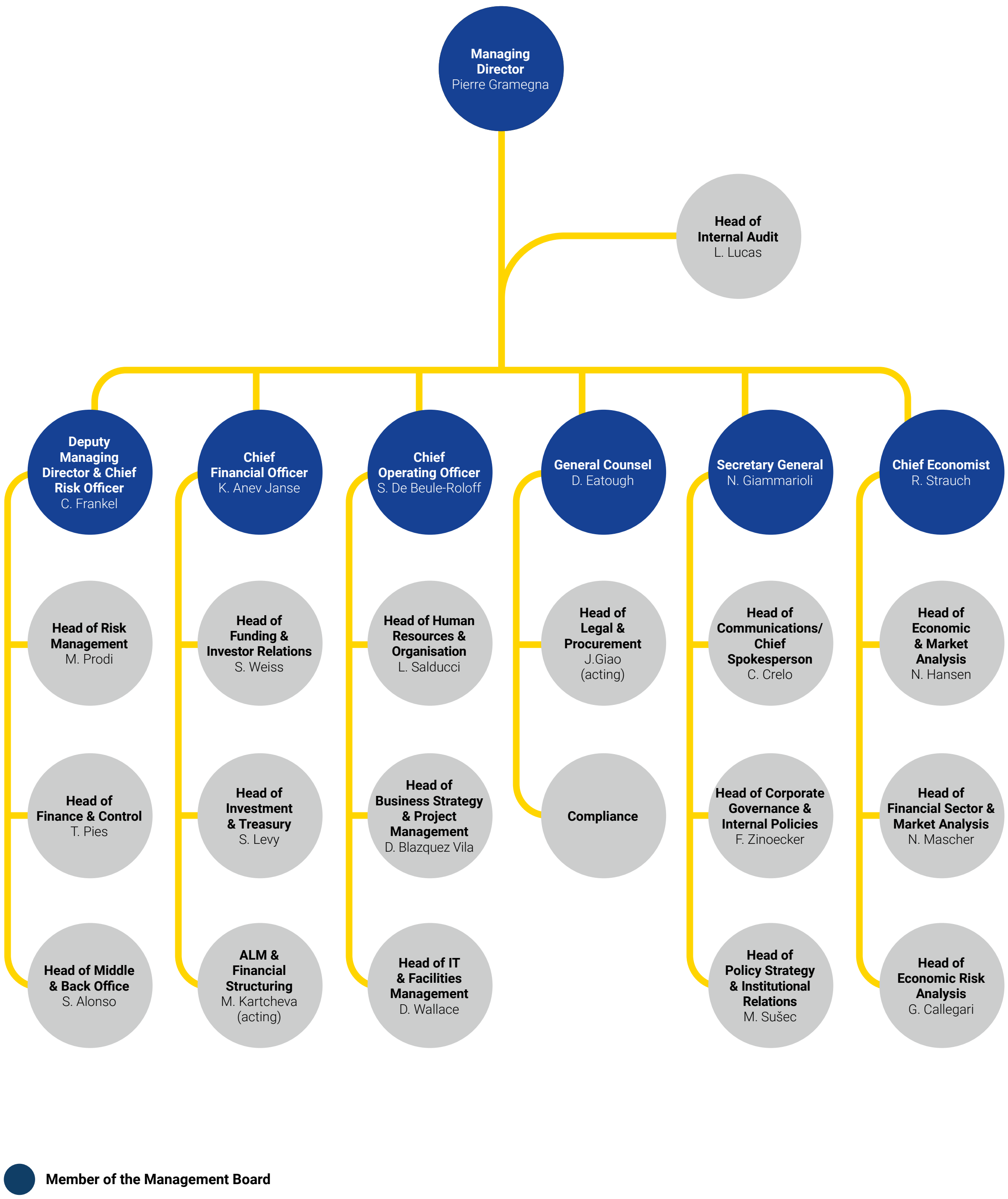
Include operational controls embedded in key processes and transactions.

IT CONTROLS

Include IT general controls, IT security controls, and IT application controls embedded in ESM systems.

WWW Visit our website for more information on our internal control framework.

ESM organisational structure



ESM Management Board

Pierre Gramegna
Managing Director

Christophe Frankel
Deputy Managing Director and Chief Risk Officer

Kalin Anev Janse
Chief Financial Officer

Sofie De Beule-Roloff
Chief Operating Officer

David Eatough
General Counsel

Nicola Giammarioli
Secretary General

Rolf Strauch
Chief Economist

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

04

Financial report

Balance sheet

As of 31 December 2022, the total ESM balance sheet was €812.7 billion. Compared to the previous year, it decreased by €14.3 billion, mainly due to a €15.3 billion decrease in *Debt evidenced by certificates* following lower liquidity needs for collateral purposes.

The €80.5 billion of paid-in capital is invested in debt securities, money market deposits or held in cash. The *Debt securities including fixed-income securities* decreased by €1.4 billion compared to 31 December 2021, from €44.4 billion to €43.0 billion.

The ESM received a scheduled repayment from Spain (€3.6 billion), in December 2022. This was recorded under *Loans and advances to euro area Member States* and was the first scheduled repayment of a Beneficiary member state.

Unrealised gains or losses resulting from the valuation of the securities portfolio are reflected in the *Fair value reserve* within the ESM's equity position. As of 31 December 2022, this reserve was negative €3.2 billion, compared to negative €44.7 million as of 31 December 2021. The decrease reflects the lower market value of securities investments compared to the previous year, largely due to the significant increase in interest rates during 2022 that negatively affected market prices of fixed income securities.

Profit and loss account

The ESM recorded a net loss of €60.2 million for the financial year 2022, compared to a net profit of €311.0 million in 2021.

The main driver of the decreased net income was the *Net profit or net loss on financial operations*, which decreased by €1.5 billion to negative €1.3 billion in 2022. It reflects the realised losses from sales of debt securities, following the rebalancing of the Paid-in capital portfolio in a rising yields environment. This decrease was partially offset by €1.1 billion in higher income on derivatives used to manage interest rate risk. As yields increased, the ESM has also started benefiting from higher yields, which were recorded under the net *Interest income/expense on debt securities including fixed-income securities* which rose to €196.0 million, compared to €132.3 million for 2021.

In 2022, the ESM received €15.2 million in compensation for the negative interest paid in 2021 on the cash balance held at the national central bank of one of its member states. This was recorded as *Extraordinary income* (€216.2 million in 2021). The other affected Members withheld their participation to the compensation mechanism in 2022, leading to a lower extraordinary income by €201.0 million compared to 2021, which contributed to the lower annual result.

Operating costs, including depreciation of tangible and intangible assets, amounted to €88.9 million in 2022 compared to €83.1 million in 2021. The increase is in line with the 2022 approved budget. The ESM provides administrative services to the EFSF for which it received a service fee of €33.1 million in 2022 (€33.1 million in 2021), recorded as *Other operating income*. The ESM continues to focus on budgetary discipline and effective cost control, as well as on ESG aspects.

Outlook for 2023

The ESM reduced the interest rate risk of the paid-in capital investments to mitigate the impact on its return from rising yields and high volatility, in line with its guidelines. However, due to the sharp yield increase across maturities during 2022 from very low and negative levels, asset valuation significantly declined. The persistence of this environment is likely to affect the ESM's net income in 2023, yet to a lesser extent, as the return should improve with positive yields.

In 2022, the war in Ukraine caused an increase in energy and commodity prices, which led to a highly uncertain global macro environment with accelerating inflation and slowdown in economic growth. Inflationary pressures also resulted from persistent trade disruptions and the concerns over energy supply, negatively impacting all European economies. In 2023, the war in Ukraine may continue to weigh on economic activity. The ESM will keep monitoring the situation closely to implement mitigating actions, as needed.

Balance sheet

As at 31 December 2022
(In €'000)

	Notes	31.12.2022	31.12.2021
ASSETS			
Cash in hand, balances with central banks and post office banks	4	55,568,448	60,401,825
Loans and advances to credit institutions			
(a) other loans and advances	5	1,959,738	7,098,396
		1,959,738	7,098,396
Loans and advances to euro area member states	6	86,210,446	89,867,531
Debt securities including fixed-income securities	7		
(a) issued by public bodies		31,940,723	21,687,738
(b) issued by other borrowers		11,085,760	22,751,012
		43,026,483	44,438,750
Intangible assets	8	149	23
Tangible assets	9	3,437	4,369
Subscribed capital unpaid	15	624,250,300	624,250,300
Prepayments and accrued income	10	1,723,277	977,392
Total assets		812,742,278	827,038,586
LIABILITIES			
Amounts owed to credit institutions	11	4,969,643	1,006,032
Debts evidenced by certificates	12		
(a) debt securities in issue		101,652,047	116,906,551
		101,652,047	116,906,551
Other liabilities	13	14,515	9,535
Accruals and deferred income	14	1,220,849	1,020,107
Total liabilities		107,857,054	118,942,225
SHAREHOLDERS' EQUITY			
Subscribed capital	15	704,798,700	704,798,700
Fair value reserve	7	(3,195,683)	(44,749)
Reserve fund	2.8.1/16	3,236,410	3,031,380
Other reserves	2.18/16	106,000	-
(Loss)/Profit for the financial year		(60,203)	311,030
Total shareholders' equity		704,885,224	708,096,361
Total equity and liabilities		812,742,278	827,038,586

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

Off-balance sheet

As at 31 December 2022
(In €'000)

	Notes	31.12.2022	31.12.2021
OFF-BALANCE SHEET			
Other items	3.6/25		
(a) notional value of interest rate swaps			
- interest rate swaps		88,330,375	71,565,500
(b) notional value of cross-currency swaps			
- receivable		10,635,161	20,066,650
- payable		(10,226,958)	(19,957,931)
(c) notional value of foreign exchange swaps			
- receivable		77,289	-
- payable		(70,637)	-
(d) notional value of futures contracts			
- bond futures		-	556,500
- interest rate futures		-	200,000

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

Profit and loss account

For the financial year ending 31 December 2022
(In €'000)

	Notes	2022	2021
Interest receivable and similar income			
(a) on cash and cash equivalents	19	150,369	-
(b) on loans and advances to credit institutions		36,070	26,502
(c) on loans and advances to euro area member states	17	1,017,765	1,001,397
(d) on debt securities including fixed-income securities	18	214,662	158,221
(e) on debts issued		146,219	223,053
(f) other	25	2,035,410	557,114
		3,600,495	**1,966,287**
Interest payable and similar charges			
(a) on cash and cash equivalents	19	(184,847)	(291,916)
(b) on loans to credit institutions		(46,880)	(61,579)
(c) on debts issued		(723,945)	(670,794)
(d) on debt securities including fixed-income securities	18	(18,627)	(25,937)
(e) other	25	(1,341,923)	(922,202)
		(2,316,222)	**(1,972,428)**
Commissions payable		**(79)**	**(38)**
Other operating income	20	**35,298**	**35,100**
(Loss)/Profit on financial operations	7/21	**(1,306,072)**	**149,016**
General administrative expenses			
(a) staff costs	22	(42,513)	(38,977)
- wages and salaries		(31,165)	(28,900)
- social security		(11,348)	(10,077)
of which relating to pension		*(9,756)*	*(8,598)*
(b) other administrative expenses	23	(44,797)	(42,346)
		(87,310)	**(81,323)**
Value adjustments in respect of intangible and tangible assets	8/9	**(1,540)**	**(1,765)**
(Loss)/Profit before extraordinary items		**(75,430)**	**94,849**
Extraordinary income	24	**15,227**	**216,181**
(Loss)/Profit for the financial year		**(60,203)**	**311,030**

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

Statement of changes in equity

For the financial year ending 31 December 2022
(In €'000)

	Subscribed capital	Fair value reserve	Reserve fund	Other reserves	Profit brought forward	Profit/(Loss) for the financial year	Total
At 1 January 2021	704,798,700	913,359	2,638,464	-	-	392,916	708,743,439
Allocation of the profit of 2020	-	-	-	-	392,916	(392,916)	-
Allocation of profit brought forward to the reserve fund	-	-	392,916	-	(392,916)	-	-
Profit for the financial year	-	-	-	-	-	311,030	311,030
Change in fair value reserve	-	(958,108)	-	-	-	-	(958,108)
At 31 December 2021	704,798,700	(44,749)	3,031,380	-	-	311,030	708,096,361

	Subscribed capital	Fair value reserve	Reserve fund	Other reserves	Profit brought forward	Profit/(Loss) for the financial year	Total
At 1 January 2022	704,798,700	(44,749)	3,031,380	-	-	311,030	708,096,361
Allocation of the profit of 2021	-	-	-	-	311,030	(311,030)	-
Allocation of profit brought forward to the reserve fund	-	-	205,030	-	(205,030)	-	-
Allocation of profit brought forward to the other reserves	-	-	-	-	(106,000)	-	(106,000)
Other reserves	-	-	-	106,000	-	-	106,000
(Loss) for the financial year	-	-	-	-	-	(60,203)	(60,203)
Change in fair value reserve	-	(3,150,934)	-	-	-	-	(3,150,934)
At 31 December 2022	704,798,700	(3,195,683)	3,236,410	106,000	-	(60,203)	704,885,224

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

Statement of cash flows

For the financial year ending 31 December 2022
(In €'000)

	2022	2021
Cash flows from operating activities:		
(Loss)/Profit for the financial year	(60,203)	311,030
Adjustments for value adjustments in respect of tangible and intangible assets	1,540	1,765
Changes in tangible and intangible assets	(734)	(699)
Changes in other liabilities	4,980	(2,030)
Changes in accrued interest and interest received	(1,279,791)	(1,188,126)
Changes in prepayments	(648,407)	(132,618)
Changes in accruals and deferred income and interest paid	883,838	423,083
Interest received	1,182,313	1,242,296
Interest paid	(683,096)	(756,452)
Net cash flow used in operating activities	**(599,560)**	**(101,751)**
Cash flows from investing activities		
Changes in debt securities including fixed-income securities	(1,738,667)	(1,144,568)
Changes in loans and advances to credit institutions	5,138,658	3,985,644
Loan repayments received during the year	3,657,085	27,157
Changes in amounts owed to credit institutions	3,963,611	22,973
Net cash flow provided by investing activities	**11,020,687**	**2,891,206**
Cash flows from financing activities		
Changes in debt securities in issue	(15,254,504)	(604,794)
Net cash flow used in financing activities	**(15,254,504)**	**(604,794)**
Net (decrease)/increase in cash and cash equivalents	(4,833,377)	2,184,661
Cash and cash equivalents at the beginning of the financial year	60,401,825	58,217,164
Cash and cash equivalents at the end of the financial year	**55,568,448**	**60,401,825**

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

Notes to the financial Statements

1. General Information

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

The Finance Ministers of the then 17 euro area countries signed a first version of a Treaty establishing the European Stability Mechanism on 11 July 2011. A modified version, incorporating amendments aimed at improving the ESM's effectiveness, was signed in Brussels on 2 February 2012 ("ESM Treaty"). The ESM Treaty entered into force on 27 September 2012 following its ratification.

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

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

The present financial statements cover the period from 1 January 2022 to 31 December 2022, while comparative figures cover the period from 1 January 2021 to 31 December 2021.

Following a proposal from the Managing Director, the Board of Directors adopted the financial statements on 30 March 2023 and authorised their submission to the Board of Governors for approval at its 15 June 2023 meeting.

1.1. GENERAL OVERVIEW OF THE FINANCIAL ASSISTANCE PROGRAMMES

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

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

1.2. OVERVIEW OF THE PRICING STRUCTURE OF THE FINANCIAL ASSISTANCE PROGRAMMES

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

- Base rate – the cost of funding incurred by the ESM, derived from a daily computation of the actual interest accrued on all bonds, bills, and other funding instruments issued by the ESM;

- Commitment fee – the negative carry and issuance costs incurred in the period between the funding by the ESM and the disbursement to the beneficiary Member State, or for the period from the refinancing of the relevant funding instrument until its maturity. The commitment fee is applied ex-post on the basis of the negative carry actually incurred;

- Service fee – the source of general revenues and resources to cover the ESM's operational costs. The service fee has two components:

  - up-front service fee (50 bps) generally deducted from the drawn amount;

  - annual service fee (0.5 bps) paid on the interest payment date;

- Margin – paid on the interest payment date. The margin charged differs across financial support instruments:

  - 10 bps for loans and primary market support facilities;

  - 5 bps for secondary market support facilities;

  - 35 bps for precautionary financial assistance;

  - 30 bps for financial assistance provided to an ESM Member for the recapitalisation of its financial institutions.

In addition, the ESM Pricing Policy includes specific elements tied to financial assistance for the Direct Recapitalisation of Institutions. This instrument is currently not used.

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

1.3. ESM FINANCIAL ASSISTANCE TO SPAIN

The Eurogroup, composed of the Finance Ministers of the euro area member states, reached political agreement on 20 July 2012 that financial assistance should be granted to Spain for the recapitalisation of its banking sector, following an official request from the Spanish government. The financial assistance was designed to cover the estimated capital requirements along with an additional safety margin, amounting to €100.0 billion. The loans were provided to Spain's bank recapitalisation fund, Fondo de Reestructuración Ordenada Bancaria (FROB), and then channelled to the relevant financial institutions. The assistance was initially committed under a European Financial Stability Facility (EFSF) programme. On 28 November 2012, the ESM Board of Governors decided that the ESM would assume this commitment, in line with Article 40(1) and (2) of the ESM Treaty.

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

On 3 December 2012, the Spanish government formally requested the disbursement of €39.5 billion in funds. On 5 December 2012, the ESM launched and priced notes, which were transferred to the FROB on 11 December 2012. The FROB used the notes in the amount of €37.0 billion for the recapitalisation of the following banks: BFA-Bankia, Catalunya-Caixa, NCG Banco, and Banco de Valencia. The FROB also provided €2.5 billion to Sareb, the asset management company, for assets arising from bank restructuring.

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

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

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

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

On 11 November 2016, the ESM received the fourth early repayment from Spain of €1.0 billion, which was approved by the ESM Board of Directors on 7 November 2016.

The ESM received two further early repayment requests from the Spanish authorities in 2017. On 14 June 2017, the ESM received the fifth early repayment from Spain of €1.0 billion, which was approved by the ESM Board of Directors on 1 June 2017. Subsequently, on 5 October 2017, the ESM received the request for the sixth early repayment from Spain of €2.0 billion, which was approved by the ESM Board of Directors on 26 October 2017 and the repayment took place on 16 November 2017.

On 30 January 2018 Spain made the request for two further early repayments. On 23 February 2018 and 23 May 2018, the ESM received respectively the seventh and eighth early repayments from Spain of €2.0 billion and €3.0 billion, which had been approved by the ESM Board of Directors on 8 February 2018. On 16 October 2018, the ESM received the ninth early repayment from Spain of €3.0 billion, which had been approved by the ESM Board of Directors on 20 September 2018.

On 12 December 2022, the ESM received a principal repayment of €3.6 billion from Spain in accordance with the scheduled repayment profile. In total, Spain has repaid €21.2 billion of its financial assistance. All repayments were made in cash.

The outstanding nominal amount of loans granted to Spain as at 31 December 2022 is €20.1 billion (2021: €23.7 billion) (refer to Note 6).

1.4. ESM FINANCIAL ASSISTANCE TO CYPRUS

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

The agreement on the macroeconomic adjustment programme led euro area member states to decide on a financial assistance package of up to €10.0 billion. On 24 April 2013, the ESM Board of Governors decided to grant stability support to Cyprus. The ESM Board of Directors subsequently approved the Financial Assistance Facility Agreement (FFA) on 8 May 2013. The ESM disbursed €6.3 billion, and the International Monetary Fund (IMF) contributed around €1.0 billion. Cyprus exited successfully from its ESM programme on 31 March 2016.

According to the terms of the FFA, the first tranche of financial assistance was provided to Cyprus in two separate disbursements: the ESM disbursed the first €2.0 billion on 13 May 2013 and transferred the second in the amount of €1.0 billion on 26 June 2013. The second tranche of assistance, €1.5 billion of ESM floating rate notes, was disbursed on 27 September 2013. The Cypriot government used the notes for the recapitalisation of the cooperative banking sector. The third tranche of assistance, €0.1 billion, was disbursed on 19 December 2013. Disbursements of a total of €1.1 billion were made in 2014, and another €0.6 billion in 2015.

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

The outstanding nominal amount of loans granted to Cyprus as at 31 December 2022 and 2021 is €6.3 billion (refer to Note 6).

1.5. ESM FINANCIAL ASSISTANCE TO GREECE

The EFSF financial assistance programme for Greece expired on 30 June 2015. On 8 July 2015, the Greek government submitted a request for financial assistance to the Chairperson of the ESM Board of Governors. On 13 July 2015, the Finance Ministers of the euro area agreed with Greece a set of urgent prior actions in order to start negotiations for a new programme under the ESM. The ESM Board of Governors approved a new programme on 19 August 2015. At the same time, the ESM Boards of Governors and Directors approved the FFA with Greece, authorising the ESM to provide Greece with up to €86.0 billion in financial assistance over three years. Greece successfully exited its programme in August 2018.

The ESM programme focussed on four key areas: restoring fiscal sustainability, safeguarding financial stability, boosting growth, competitiveness and investment, and reforming the public administration. The funds available under the FFA were earmarked to cover needs related to debt servicing, banking sector recapitalisation and resolution and budget financing. To return its economy to growth and make its debt burden more sustainable, the Greek government committed to a series of far-reaching economic reforms.

On 20 August 2015, the ESM approved the first tranche of €26.0 billion in financial assistance for Greece, divided in two sub-tranches. This decision followed the ESM Board of Directors' approval of the FFA, specifying the terms of the financial assistance. The Board of Directors also decided to immediately disburse €13.0 billion in cash to Greece. This was the first disbursement under the first sub-tranche, of €16.0 billion, to be used for budget financing and debt servicing needs. The second sub-tranche, of €10.0 billion, was immediately created in ESM floating rate notes and held in a segregated account. These funds were designated to cover the Greek banking sector's potential resolution and recapitalisation costs, with release decisions to be taken on a case-by-case basis.

On 23 November 2015, the Board of Directors authorised the disbursement of €2.0 billion in cash to Greece as the second disbursement under the €16.0 billion sub-tranche approved in August 2015. This decision followed the Greek government's completion of the first set of reform milestones. This disbursement was primarily used for debt servicing.

On 1 December 2015, the Board of Directors decided to release €2.7 billion to Greece to recapitalise Piraeus Bank. Subsequently, on 8 December 2015, the Board of Directors decided to release €2.7 billion to Greece to recapitalise the National Bank of Greece. The ESM transferred these amounts under the €10.0 billion sub-tranche, held in ESM notes in a segregated account. The availability period of the remaining €4.6 billion expired on 31 January 2016.

On 22 December 2015, the Board of Directors approved the disbursement of €1.0 billion to Greece as the third and final disbursement under the €16.0 billion sub-tranche agreed in August 2015. This decision followed the Greek government's completion of the second set of reform milestones. This disbursement was also used for debt servicing.

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

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

On 20 January 2017, the ESM Board of Directors approved three schemes aimed at reducing interest rate risk for Greece. The first was a bond exchange, where floating rate notes disbursed by the ESM to Greece for bank recapitalisation were exchanged for fixed coupon notes. The second scheme allowed the ESM to enter into swap arrangements to reduce the risk that Greece would have to pay a higher interest rate on its loans in case market rates start rising. The third scheme, which entailed issuing long-term bonds that closely matched the maturity of the Greek loans, was eventually replaced by additional swap arrangements.

On 20 February 2017, the ESM received a loan repayment of €2.0 billion from the Greek government. The repayment was a contractual obligation with the ESM and followed the sale of an asset by one of the banks that took part in the 2015 banking recapitalisation, financed with ESM loans.

On 7 July 2017, the ESM Board of Directors approved the first disbursement of the €7.7 billion under the third tranche of €8.5 billion. Out of this amount, €6.9 billion was used for debt servicing needs and €0.8 billion for arrears clearance.

On 26 October 2017, the ESM Board of Directors approved the disbursement of €0.8 billion to Greece for the clearance of arrears.

On 27 March 2018, the ESM Board of Directors approved the fourth tranche of €6.7 billion to Greece for debt service, domestic arrears clearance and for establishing a cash buffer. The ESM Board of Directors approved the release of the first disbursement under this tranche amounting to €5.7 billion, which took place on 28 March 2018.

On 14 June 2018, the ESM Board of Directors authorised the release of the remaining amount of the fourth tranche of ESM financial assistance, approved on 27 March 2018. The disbursement of €1.0 billion was used for the clearance of arrears.

On 6 August 2018, the ESM disbursed the fifth and final tranche of ESM financial assistance for Greece, amounting to €15.0 billion. Out of this tranche, €9.5 billion was used for building up Greece's cash buffer and €5.5 billion was used for debt service.

On 20 August 2018, Greece officially concluded its three-year ESM financial assistance programme. This followed the disbursement of a total of €61.9 billion by the ESM over three years in support of macroeconomic adjustment and bank recapitalisation in Greece. The remaining €24.1 billion available under the maximum €86.0 billion programme volume was not utilised and was automatically cancelled.

Greece repaid €27.2 million on 15 June 2021 and €14.3 million on 21 June 2022 using part of the respective dividends for 2019 and 2020 received from the Hellenic Corporation of Assets and Participations (HCAP).

The outstanding nominal amount of loans granted to Greece as at 31 December 2022 is €59.8 billion (2021: €59.8 billion) (refer to Note 6).

1.6. ESM COVID-19 PANDEMIC CRISIS SUPPORT

On 9 April 2020, the Eurogroup decided on a comprehensive economic policy response to the COVID-19 crisis. Three important safety nets for workers, businesses and sovereigns were established, amounting to a package worth €540 billion. The ESM was assigned the role of a safety net for sovereigns and for this purpose created a Pandemic Crisis Support instrument. It was a credit line to support domestic financing of healthcare related costs due to the COVID-19 crisis, which could be requested by all ESM Members. On 23 April 2020, the EU Heads of State or Government (European Council) endorsed this agreement. On 8 May 2020, the Eurogroup agreed on the features of the credit line. It was made operational by the ESM Board of Governors on 15 May 2020. The Pandemic Crisis Support was available until 31 December 2022; no Member State had requested this credit line by the aforementioned date.

2. Summary of significant accounting policies

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

2.1. BASIS OF PRESENTATION

The accompanying financial statements are prepared and presented in accordance with Directive 86/635/EEC of the Council of the European Communities of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions, as amended by Directive 2001/65/EC of 27 September 2001, by Directive 2003/51/EC of 18 June 2003 and by Directive 2006/46/EC of 14 June 2006 (the 'Directives'). Their specific application by the ESM is described in the subsequent notes.

The ESM prepares an annual report in respect of each financial year and submits it to the Board of Governors for approval at its annual meeting. The annual report contains a description of the policies and activities of the ESM, the financial statements for the relevant financial year, the report of the external auditors in respect of their audit in respect of said financial statements, and the report of the Board of Auditors in respect of said financial statements pursuant to Article 24(6) of the ESM By-Laws.

The preparation of financial statements in conformity with the Directives requires the use of certain critical accounting estimates. It also requires management[10] to exercise its judgement in applying the ESM's accounting policies. Areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the financial statements are disclosed in Note 2.4.

2.2. CHANGES IN ACCOUNTING POLICIES

As of 1 January 2021, the ESM changed the accounting policy for the calculation of the net profit from sales of securities, included in "Debt securities including fixed income securities", from FIFO (first-in-first-out) to AVCO (average cost) to align with common business and accounting practice in financial institutions. The effect of the change on the existing portfolio was recognised as a one-off charge for the period, which is included in "net profit on financial operations" within the profit and loss account. Further disclosures are provided in Note 18 in relation to this change in the accounting policy.

2.3. BASIS OF MEASUREMENT

The accompanying financial statements are prepared on a historical cost basis, except for debts evidenced by certificates which are measured at amortised cost, and part of the paid-in capital and reserve fund investments which are measured at fair value with gains and losses recognised in the fair value reserve. Bond and interest rate futures are measured at fair value with the changes in the values (mark-to-market) recognised in the profit and loss account.

2.4. USE OF ESTIMATES

In preparing the financial statements, management is required to make estimates and assumptions that affect reported income, expenses, assets, liabilities and the disclosure of contingent assets and liabilities. The use of available information and application of judgement are inherent to the formation of estimates.

Actual results in the future could differ from such estimates and the resulting differences may be material to the financial statements. Any revision to accounting estimates is recognised prospectively in current and future periods.

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

The ESM reviews its loans and advances to beneficiary Member States at each reporting date, to assess whether a value adjustment is required (refer to Note 2.9). Such assessment requires judgement by the management and the ESM governing bodies, consistent with the ESM's mandate as a crisis resolution mechanism that aims at supporting beneficiary Member States' return to public financial stability.

No value adjustment was required as at 31 December 2022 and 2021, thus none has been recorded.

2.5. FOREIGN CURRENCY TRANSLATION

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

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

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

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

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

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

2.6. DERIVATIVE FINANCIAL INSTRUMENTS

The ESM uses derivatives instruments for risk management purposes. Cross-currency swaps, foreign exchange swaps and forwards are used to hedge the currency risk into euro[11] (refer to Note 3.3.2), and interest rate swaps to manage the interest rate risk exposure (refer to Note 3.3.1).

All cross-currency swaps, foreign exchange swaps, forwards and interest rate swaps transactions are booked at notional amount as off-balance sheet items at the date of the transaction.

The ESM uses also short-term interest rate and bond futures contracts to manage the interest rate risk of the paid-in capital portfolios (refer to Note 3.3.1). The futures transactions are booked at notional amount as off-balance sheet items at the date of the transaction.

2.6.1. FOREIGN EXCHANGE SWAPS AND FORWARDS

For the management of its paid-in capital portfolios as well as issuances in USD, the ESM can enter into foreign exchange swaps and forwards to hedge back into euro non-euro denominated instruments. Ongoing forward and spot exchange transactions are converted at the spot rates of exchange prevailing on the balance sheet date and neutralised in 'Accruals and deferred income' or 'Prepayments and accrued income'. The spread between the spot amount and forward settlement amount is linearly amortised through the profit and loss account in 'Interest receivable and similar income' or 'Interest payable and similar charges'. On the maturity date, the parties exchange the initial principal amounts at the contractual exchange rate. The difference between the spot and the forward rate at maturity is recognised under the caption 'Interest receivable and similar income' or 'Interest payable and similar charges' in the profit and loss account.

2.6.2. CROSS-CURRENCY SWAPS AND INTEREST RATE SWAPS

The ESM enters into cross-currency swaps in order to hedge investments in non-euro denominated assets in its paid-in capital portfolios as well as issuances in USD. In a cross-currency swap, payments are exchanged based on either two floating reference rates, one floating rate and one fixed rate, or two fixed rates, each with a corresponding notional amount denominated in a different currency from a given security (the asset). Notional amounts are exchanged on the effective date and the maturity date. Ongoing forward and spot exchange transactions are converted at the spot rates of exchange prevailing on the balance sheet date and neutralised in 'Accruals and deferred income' or 'Prepayments and accrued income'.

The spread between the spot amount and forward settlement amount is linearly amortised through the profit and loss account in 'Interest receivable and similar income' or 'Interest payable and similar charges'. Interest payments exchanged are also included in 'Interest receivable and similar income' or 'Interest payable and similar charges' in the profit and loss account.

An interest rate swap is a contract under which floating-rate interest is exchanged for fixed-rate interest or vice-versa. Interest received and paid under interest rate swaps is accrued and reported under 'Interest receivable and similar income' or 'Interest payable and similar charges' in the profit and loss account.

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

On the maturity date the difference between the payable and the receivable interest at maturity is recognised under the caption 'Interest receivable and similar income' or 'Interest payable and similar charges' in the profit and loss account.

All interest rate swaps and cross-currency swaps contracted with commercial counterparties are concluded under the contractual framework of ISDA swap agreements and Credit Support Annexes (CSA), which specify the conditions of exposure collateralisation, in order to offset mark-to-market fluctuations on a daily basis through the exchange of collateral. These are generally accepted and practised contract types (see also Note 3.6.3). Derivative operations concluded with selected highly rated public institutions or central banks can be concluded under ISDA swap agreement only.

The cash collateral received or provided is reported under 'Amounts owed to credit institutions' or 'Loans and advances to credit institutions'.

2.6.3. FUTURES CONTRACTS

Futures contracts are financial instruments, which provide the ability to buy or sell an underlying item on a forward date, at a pre-agreed price. Futures contracts are standardised exchange-traded derivative instruments with pre-defined maturity, underlying items and specifications. The ESM enters into bond futures and short-term interest rate futures.

At the delivery date of the contract, if positions have not been closed or rolled to the next contract, short bond futures positions must deliver a bond from a pre-set basket of possible deliverable bonds, with a pre-defined remaining maturity, to the long positions. The holder of the short interest rate futures position must deliver the interest earned on a notional amount of the contracts to the holder of the long position (or vice versa if the interest rate is negative).

The ESM enters in futures contracts with the objective to manage the interest rate risk of the paid-in capital portfolios. The futures are initially recognised at zero including any transaction costs, and measured subsequently at fair value with gains and losses recognised in the profit and loss account under the caption 'Interest receivable and similar income – Other' or 'Interest payable and similar charges – Other'.

The changes in the values (mark-to-market) of futures positions are recognised in the profit and loss account through the daily margin calls. Therefore, the carrying amounts of futures represent only the called but not yet settled balances and are recognised under the caption 'Other assets' or 'Other liabilities'.

2.6.4. INTEREST RATE BENCHMARK REFORM (IRBR)

Interest rate benchmarks, such as the Euro Overnight Index Average (EONIA), are widely used in financial contracts. In recent years, confidence in their reliability and robustness has been undermined, and regulators across the globe have been pushing for a reform of interest rate benchmarks. The global transition to alternative interest rate benchmark rates replacing Interbank Offered Rates (IBORs) for different currencies is one of the most challenging reforms to be undertaken in the financial markets with major main milestones due to be achieved by the end of 2021.

In September 2017, the European Central Bank (ECB), the Financial Services and Markets Authority (FSMA – Belgian market supervisor), the European Securities and Markets Authority (ESMA) and the European Commission announced the launch of the industry working group on euro risk-free rates (RFR). The working group recommended that the euro short-term rate (€STR) becomes the successor to EONIA in September 2018. In order to ensure smooth market adoption, a two-year transition period was applied in two phases.

The first phase dealt with pre-replacement issues (issues affecting financial reporting in the period before the replacement of an existing interest rate benchmark). The first phase of the project culminated with the Interest Rate Benchmark Reform amendments published in September 2019.

The second phase of the project dealt with replacement issues (issues that might affect financial reporting when an existing interest rate benchmark is replaced). To address it, a dedicated sub-working group on financial accounting and risk management has been created to specifically analyse the impact on financial accounting and risk management of the transition from EONIA to €STR. The sub-group comprised representatives of European and international credit institutions (including the ESM), consulting and accounting firms, clearing houses, investment management firms and associations. The ECB, ESMA, the European Commission, and the FSMA act as observers in the sub-group.

The potential discontinuation of such benchmarks raises the question of how contracts indexed to them (only applies to swaps for the ESM) will be affected. In case the market standards do not lead to the discontinuation of the various IBORs in a consistent way, this could expose the ESM to basis risks between the various versions of IBORs' successors. The exposure to basis risks is not specific to the ESM and it has been recognised in the IBOR Global Benchmark Transition Report, published by the largest industry associations in June 2018, as one of the biggest challenges in the benchmark reform.

Changes to the basis for determining contractual cash flows as a result of interest rate benchmark reform are required, as a practical expedient, to be treated as changes to a floating interest rate, provided that, for the financial instrument, the transition from the IBOR benchmark to RFR takes place on an economically equivalent basis.

In the context of IBOR reform, the ESM's assessment of whether a change to an amortised cost financial instrument is substantial, which was made after applying the practical expedient introduced by IBOR reform during the second phase. This requires the transition from an IBOR to an RFR to be treated as a change to a floating interest rate, where the effective interest rate will be updated without modifying the carrying amount of the financial instrument.

As part of its investment and funding activities, the ESM is only exposed to IBOR transition on derivative instruments used for risk management purposes.

As a consequence of the reform, a new rate called euro short-term rate (€STR) replaced the EONIA and became the official euro risk-free-rate (RFR) benchmark on 3 January 2022. As a result, since 1 October 2019, EONIA is no longer computed but calculated as €STR +8.5bp. This reform had an impact on all remunerations and valuations currently based on EONIA (i.e. derivatives for the ESM). For derivatives, this affected the remuneration of posted derivatives collateral as well as the discounting rate used for the valuation of existing and future interest rate- and cross-currency swaps.

The transition to €STR flat from EONIA flat for the remuneration of cash collateral for derivatives and consequently of the discount curve (CSA based discounting) resulted in one-off compensation fee payments to offset the mark-to-market losses that one counterparty faced following the shift of the discount curve by around 8.5 bps. The purpose of the compensation was to maintain the same financial status as before the change for both counterparties to the contract (net zero impact).

In 2021, the ESM already agreed with all existing commercial counterparties the transition to €STR and received or paid compensation accordingly. The compensation payments were agreed and paid separately for the outstanding funding and investment exposures with each counterparty. The one-off cash compensation is recognised in the ESM's profit and loss account at trade date for the investment-related activities (refer to Note 25). The compensation received for the funding activity-related derivatives (refer to Note 3.6.1) was directly and fully retroceded to the beneficiary Member States.

This reform did not have an impact on the ESM's 2022 financial figures.

2.7. CASH IN HAND, BALANCES WITH CENTRAL BANKS AND POST OFFICE BANKS

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

2.8. DEBT SECURITIES INCLUDING FIXED-INCOME SECURITIES

The ESM has established the following portfolios for the management of its financial assets:

2.8.1. PAID-IN CAPITAL AND RESERVE FUND INVESTMENTS

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

The paid-in capital and the reserve fund (the Investment Portfolios) are invested in accordance with the ESM Investment Guidelines approved by the Board of Directors. The main objective of such investments is to ensure liquidity, the availability of maximum lending volume and support the creditworthiness of the ESM.

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

According to the ESM Investment Guidelines, any currency risk shall be hedged into euro to ensure a limited remaining foreign exchange risk for the ESM. Derivatives shall be used for risk management purposes (refer to Note 3.6.2).

In accordance with the Investment Guidelines, the Investment Portfolios are divided in the Short-term tranche, the Medium- and long-term tranche and the Hold-to-maturity tranche. The assets of the reserve fund are invested in full in the Short-term tranche:

Short-term tranche (STT)

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

Medium/ Long-term tranche (MLTT)

The main objective of the Medium/ Long-term tranche is to ensure the ESM's financial strength. This tranche is managed to enhance the return of the Investment Portfolios, subject to the investment objectives and constraints specified in the Investment Guidelines. This tranche is also mainly invested in liquid instruments.

Hold-to-maturity tranche (HTMT)

The objective of the Hold-to-maturity tranche is to reinforce the long-term financial strength of the ESM. This tranche shall be invested to enhance the return of the Investment Portfolios, subject to the other investment objectives specified in the Investment Guidelines.

The assets in the Hold-to-maturity tranche are intended to be held to maturity, and may be monetised only:

i. to raise liquidity if, in accordance with the ESM High Level Risk Policy, it is necessary to meet due payments to ESM creditors and to avoid or limit a capital call under Article 9(3) of the ESM Treaty; or

ii. outside of the situation referred in "i" above, to post collateral for derivatives used for risk management purposes in the Investment Portfolios;

iii. In case any asset loses its eligibility, the ESM may decide to reduce the exposure to this given asset, within an appropriate timeframe and manner to minimise any impact on market prices.

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

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

The paid-in capital investments in the Hold-to-maturity tranche are initially recognised at cost and measured subsequently at amortised cost.

As of 1 January 2021, the ESM has changed the accounting policy for the calculation of net profit of the securities sales from FIFO (first-in-first-out) to AVCO (average cost). This change led to a one-off charge for the financial year 2021, which is included in the net profit on financial operations (refer to Note 7 and Note 21). For the financial year 2022, no such one-off charge has been recognised.

2.8.2. LIQUIDITY BUFFER INVESTMENTS

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

As per the ESM Investment Guidelines, the management of the liquidity buffer follows the same investment restrictions as the Short-term tranche of the paid-in capital described in Note 2.8.1.

2.8.3. DETERMINATION OF FAIR VALUE

The determination of fair values of financial assets and liabilities is based on quoted market prices or dealer price quotations, when such prices are regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis.

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

2.9. LOANS AND ADVANCES TO CREDIT INSTITUTIONS AND TO EURO AREA MEMBER STATES

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

Transaction costs and premiums/discounts are amortised in the profit and loss account through interest receivable and similar income. Interest income on loans and advances to credit institutions and to euro area member states are also included in 'Interest receivable and similar income' in the profit and loss account (refer to Note 2.19).

Specific value adjustments are accounted for in the profit and loss account in respect of loans and advances presenting objective evidence that all or part of their outstanding balance is not recoverable (refer to Note 2.4) and are deducted from the corresponding asset in the balance sheet.

The underlying securities purchased under the agreements to resell ("reverse repos") are not recognised on the balance sheet while the consideration paid is recorded as loans and advances to credit institutions as appropriate. The counterparties enter into an irrevocable commitment to complete the operation on a date and a price fixed at the outset. The difference between the sale and the repurchase price is treated as interest and recognised over the life of the agreement (refer to Note 5).

2.10. INTANGIBLE ASSETS

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

2.11. TANGIBLE ASSETS

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

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

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

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

2.12. PREPAYMENTS AND ACCRUED INCOME

Prepayments and accrued income are related either to invoices received and paid in advance for expenses related to subsequent reporting periods, or to any income related to the reporting period which will only be received in the course of a subsequent financial year. It includes the spot revaluation, the spread amortisation and also the accrued interest income of ongoing derivative transactions (refer to Note 2.6).

2.13. AMOUNTS OWED TO CREDIT INSTITUTIONS

Amounts owed to credit institutions are presented in the financial statements at their redemption amounts. Transaction costs and premiums/discounts are amortised in the profit and loss account through interest payable and similar charges/income (refer to Note 2.19). Interest expense on amounts owed to credit institutions is also included in 'Interest payable and similar charges' in the profit and loss account.

The underlying securities sold under the repurchase agreements ("repos") are not derecognised on the balance sheet while the consideration received is recorded as amounts owed to credit institutions as appropriate and carried at the amounts of the cash received on the balance sheet. The counterparties enter into an irrevocable commitment to complete the operation on a date and a price fixed at the outset. The difference between the sale and the repurchase price is treated as interest and recognised over the life of the agreement (refer to Note 11).

2.14. DEBTS EVIDENCED BY CERTIFICATES

Debts evidenced by certificates are presented at their amortised cost. Transaction costs and premiums/discounts are amortised in the profit and loss account through 'Interest payable and similar charges'. Interest expenses on debt instruments are also included in 'Interest payable and similar charges' in the profit and loss account (refer to Note 2.19).

2.15. PROVISIONS

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

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

2.16. SUBSCRIBED CAPITAL

On 31 December 2022 and 31 December 2021, the ESM's shareholders were the 19 euro area member states. In accordance with Article 8 of the ESM Treaty, the authorised capital is €704.8 billion, which is divided into 7,047,987 shares, with a nominal value of €100,000 each. The authorised capital was subscribed by the shareholders according to the contribution key provided in Article 11 and calculated in Annex I of the ESM Treaty. The authorised capital is divided into paid-in shares and callable shares, where the total aggregate nominal value of paid-in shares is €80.5 billion.

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

2.17. ACCRUALS AND DEFERRED INCOME

Accruals and deferred income are related to payments received before the balance sheet date but not exclusively related to the reporting period, together with any charges which, though relating to the financial year in question, will only be paid in a subsequent financial year. It includes the spot revaluation, spread amortisation and also the accrued interest expense of ongoing derivative transactions (refer to Note 2.6).

2.18. OTHER RESERVES

On 11 June 2020, the Board of Governors approved the establishment of a special reserve fund for the new ESM building pursuant to Article 24 of the ESM Treaty and invited the Board of Directors to adopt the rules required for the establishment, administration, and use of such building fund reserve to facilitate timely execution of the new ESM building project. On 16 June 2022, the Board of Governors, at its annual meeting approved the allocation of €106 million from the ESM's 2021 annual profit to the Other reserves.

In accordance with Article 4 of 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, the other reserve is recognised in equity with the amount approved by the Board of Governors resolution as of 16 June 2022 allocating part of the 2021 ESM's annual profit.

On July 2022, the ESM signed a framework agreement for the construction of the new building with the Grand Duchy of Luxembourg. This agreement sets forth the conditions and terms under which the project will be executed, and also outlines the signatories' duties and obligations in the years ahead. Taking into account prevailing economic conditions, the impact of rapidly increasing and volatile construction prices on the overall costs of the project cannot be fully quantified at this point.

2.19. INTEREST RECEIVABLE AND PAYABLE

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

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

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

2.20. EMPLOYEE BENEFITS

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

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

2.21. COMPENSATION PAYMENTS FROM ESM MEMBERS

Payments received from a Member State as compensation for expenses or losses (refer to Note 24) incurred in a previous period are recorded as 'Extraordinary income' in profit or loss of the period in which they become receivable. Such compensation payments are made with a view to preserve the ESM's capital and are granted on a case-by-case basis, subject to conditions not controlled by the ESM. Therefore, a receivable is evidenced either through a notification of the payment or the respective transfer of money.

2.22. TAXATION

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

3. Risk management

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

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

3.1. RISK MANAGEMENT ORGANISATION

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

According to the ESM's High Level Risk Policy (published on the ESM website) and its Annex, the targeted risk appetite should preserve the ESM's funding capacity, ensure the highest creditworthiness, and avoid unexpected capital calls. The High-Level Risk Policy and its Annex describe the risk appetite and the framework for identifying, assessing, monitoring and managing risks consistent with the risk appetite. It covers all ESM financial and non-financial risks, and both on- and, if applicable, off-balance sheet items. The risk profile is defined by a set of limits to maintain all types of risks within the risk appetite. The ESM does not aim at generating profit on financial support granted to beneficiary Member States and aims to manage its investment portfolios prudently, in accordance with the ESM Investment Guidelines and ESM's risk policies.

The ESM operates under the principles of the three lines of defence approach: departments and business functions assume direct responsibility for day-to-day risk management. All staff are responsible for ensuring that risks relating to their operations are identified, followed up, and reported to Risk Management. Risk Management exercises central oversight of risk and ensures that all business functions, comprehensively and consistently, implement the risk management framework.

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

The Chief Risk Officer (who is also the ESM's Deputy Managing Director) reports directly to the Managing Director. The Chief Risk Officer is responsible and accountable for informing the Managing Director on all risks which the institution may face to ensure enforcement and oversight. The Managing Director reports risk-related information to the Board of Directors, principally through the Board Risk Committee.

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

The ESM established an information security function within the Risk division to provide independent oversight and monitoring of information technology operations and other 'first line of defence' divisions managing information security. The aim is to strengthen the confidentiality, integrity, and availability of valuable or sensitive information and enhance resilience to cyber security risks. The information security function establishes risk guidelines for the ESM's information security strategy and for the design of information security controls. The function also maintains the ESM's information security policy and conducts periodic reviews of user access to information.

War in Ukraine and risk management response

In 2022, the war in Ukraine caused an increase in energy and commodity prices which led to an acceleration of inflation, and a high uncertainty resulting in a slowdown in economic growth globally. Persistent trade disruptions, the concerns over sufficient and stable energy supply, and the subsequent surge in energy and production costs led to high inflation that negatively impacted all European economies.

During 2022, the ESM risk assessment and impairment assessment methodology duly captured (via its Early Warning System) the severe impact from the war, together with the related risks and the recent developments. In particular, the assessment focused on whether the effects of the war triggered a significant increase in credit risk and if it would materialise in an expected credit loss (ECL). In that context, a complete assessment of a wide range of inputs based on forward-looking information was performed, to ensure a comprehensive assessment of all short-term and medium-to-long term factors and consequences. As described above, inputs include short-term economic data, vulnerability indicators, liquidity balances and market indicators, together with medium-to-long term risks, policy measures and mitigating factors.

All those factors have and are expected to continue to adequately balance the economic shock caused by the war and address the related risks.

Early on in 2022, the ESM performed an assessment of issuers and that could face negative credit developments amidst the war in Ukraine, because of direct or indirect exposure to Ukraine and/or Russia. The results and any preventive mitigating actions were discussed in risk committees. Risk Management continued to closely monitor credit risk developments of these issuers and relevant credit risk developments, which were also discussed in risk committees on a regular basis.

Considering all these elements, as of 31 December 2022 the assessment did not identify a significant increase in credit risk on the ESM's exposures to beneficiary Member States. The overall credit quality of the ESM loans portfolio remained stable.

3.2. CREDIT RISK

Credit risk is defined as the potential for loss arising from the inability of a counterparty, issuer, or other obligor to fulfil its contractual obligations for full value when due as a result of a significant deterioration in creditworthiness. Counterparty risk includes potential for loss arising from default of a counterpart to derivatives contracts, which are used by both investment and funding activities for risk management. Issuer risk is a particular form of credit risk and derives from investment in securities of the paid-in capital, reserve fund and excess liquidity. Credit concentration risk is defined as the potential for loss arising from undiversified, correlated exposure to a particular group of counterparties.

Given the nature of the ESM's mandate, where credit risk from lending arises as a result of support to beneficiary Member States under a financial assistance facility agreement (FFA), the credit risk in the ESM's lending exposure is accepted. The ESM has established an early warning procedure to ensure that it receives any repayments due by a beneficiary Member State under a FFA in a timely manner. The note 3.2.4 below further describes the ESM's treatment of loans to euro area member states.

3.2.1. EXPOSURE TO CREDIT RISK WITHOUT TAKING INTO ACCOUNT ANY COLLATERAL OR OTHER CREDIT ENHANCEMENTS

The following table shows the direct exposure to credit risk for the components of the balance sheet. For on-balance-sheet positions, these exposures are based on net carrying amounts as reported on the balance sheet.

(in €'000)	Exposure 31.12.2022	Exposure 31.12.2021
Cash in hand, balances with central banks and post office banks	55,568,448	60,401,825
Loans and advances to credit institutions	1,959,738	7,098,396
Debt securities including fixed-income securities	43,026,483	44,438,750
On balance sheet credit risk exposure	**100,554,669**	**111,938,971**
Exposure at default on derivatives [1]	2,404,393	1,651,622
Credit risk exposure	**102,959,062**	**113,590,593**

[1] The cash-collateral is included in the calculation of the Exposure at Default and reported as exposure in the on balance sheet items.

This table does not include the loans and advances to euro area member states as the ESM does not manage the credit risk on beneficiary Member States, while it monitors its exposures through the Early Warning System, as described in Note 3.2.4.

3.2.2. RISK PROFILE OF COUNTERPARTIES AND ISSUERS

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

These tables do not include the breakdown of the 'Loans and advances to euro area member states', as the ESM risk function does not manage the inherent risk of non-payment of the beneficiary Member States, as described in Note 3.2.4.

(in €'000)	Credit rating[1]	Clean carrying value 31.12.2022
Cash in hand, balances with central banks and post office banks	not rated[2]	55,564,825
	AA	3,623
Loans and advances to credit institutions	not rated[3]	1,706,989
	AA	1,719
	AA-	110,150
	A+	139,150
	A-	1,730
Debt securities including fixed-income securities	AAA	22,945,753
	AA+	5,409,198
	AA	9,606,694
	AA-	3,188,048
	A+	929,105
	A	947,685
Total		**100,554,669**

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

(in €'000)	Credit rating[1]	Clean carrying value 31.12.2021
Cash in hand, balances with central banks and post office banks	not rated[2]	60,395,136
	AA	6,689
Loans and advances to credit institutions	not rated[3]	949,799
	AA	1,107,053
	AA-	403,299
	A+	2,811,275
	A	344,590
	A-	1,482,380
Debt securities including fixed-income securities	AAA	25,688,225
	AA+	3,635,186
	AA	7,480,937
	AA-	1,485,344
	A+	1,028,412
	A	5,120,646
Total		**111,938,971**

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

3.2.3. CREDIT RISK ON DEBT SECURITIES INCLUDING FIXED-INCOME SECURITIES

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

3.2.4. CREDIT RISK IN RELATION TO LOANS TO EURO AREA MEMBER STATES

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

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

The ESM provided financial assistance to Spain for the recapitalisation of its financial sector, which must be repaid by 2027. The ESM also provided financial assistance to Cyprus, which implemented a macroeconomic adjustment programme. Furthermore, starting from August 2015, the ESM provided financial assistance to Greece. Note 6 provides a breakdown of all disbursed amounts, as well as the movements during the year.

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

3.3. MARKET RISK

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

3.3.1. INTEREST RATE RISK

Interest rate risk is defined as the potential for loss arising from adverse movements in interest rates. The main sources of interest rate risk include asset or liability re-pricing following market movements, yield curve shifts, and changes in interest rate credit spread.

Interest rate risk on Lending and Funding is the risk of a mismatch between the interest rate re-pricing of loans granted to beneficiary Member States and of its funding raised through bills and bond issuances. The exposure to interest rate risk arises from differences in repricing and maturity characteristics of the different asset, liability, and hedging instruments.

All funding costs are passed through to beneficiary Member States under financial assistance, as defined by the ESM Pricing Policy.

Interest rate risk on investments is the risk of market loss due to an adverse change in the overall level of interest rates affecting the value of the investment portfolios' holdings. This risk is monitored and controlled daily through risk indicators and stress tests. Duration bands, cumulated and partial sensitivities, one day Value at Risk (VaR) with a 99% level of confidence are part of the daily measures that frame the interest rate risk potential exposure. To complement these measures, a series of stress tests with flattening, steepening and parallel shifts of all or a selected number of interest rate curves is processed daily as part of the risk report.

In addition, capital volatility and capital preservation measures frame and limit the Short-term and the Medium/Long-term tranches interest rate risk exposures in line with the Risk Appetite of the Institution as described and published in the ESM Investment Guidelines.

Capital volatility is defined as a yearly limit to market losses over a one-year horizon for the Medium/Long-term tranche. The one year VaR 99% should be lower than 3% of the market value of the tranche.

Capital preservation is defined as protecting shareholders from losses on the paid-in capital, which currently stands at €80.5 billion. The market value of the Short-term tranche (including the Reserve Fund) and the Medium/Long-term tranche, together with the Hold-to-maturity tranche valued at amortised cost, shall not fall below this value over a relevant investment horizon, for a high level of confidence. The relevant investment horizon is set in relation to the nature of each portfolio:

- For the Short-term tranche, the capital shall be preserved at a one-year horizon, for a high level of confidence, to the extent possible considering prevailing market conditions.

- For the Medium/Long-term tranche, the capital shall be preserved at a three-year horizon for a high level of confidence, to the extent possible considering prevailing market conditions.

To assess capital preservation with a 'high level of confidence', a vast array of scenarios of interest rate movements are used to analyse the market value evolution of the Short-term and the Medium/Long-term tranches investments over the relevant investment horizons.

Scenario analyses are different to sensitivity analysis as they assess the impact of a range of different setups and correlations over a multi-year period, while sensitivity analysis assesses the linear and instantaneous impact to a given change in interest rates.

These scenarios, developed in cooperation with Investment and Treasury, are agreed at the Internal Risk Committee (IRC) and endorsed by the Board Risk Committee (BRC).

Capital preservation scenario analysis results are reported at least once a year to IRC/BRC and for any major investment portfolio strategy proposal to the Investment Management Committee (IMC).

The preservation of the maximum lending capacity of the ESM requires the investment portfolios' market value to remain above €75.0 billion, with the Short-term, Medium/Long-term and Hold-to-maturity tranches valued in mark-to-market. However, the Hold-to-maturity tranche is considered as being interest rate insensitive in the other risk measures as it is valued at amortised cost.

Derivatives contracted with commercial banks are fully collateralised, thanks to the exchange of cash and highly rated securities, regulated by collateral agreements (ISDA and Credit Support Annex).

The interest rate risk on the ESM investment portfolios is managed prudently to support the ESM's financial stability mandate, which requires the ESM to maintain financial soundness including periods of market stress.

3.3.2. CURRENCY RISK

Currency risk is defined as the potential for loss arising from changes in exchange rates and shall be minimised by limiting net currency exposure, in line with the risk appetite of the Institution.

The ESM is exposed to currency risk whenever there is a currency mismatch between its assets and liabilities. Potential sources of currency risk are paid-in capital investments in non-euro denominated assets and funding activities in foreign currencies.

In 2022 and 2021, the ESM undertook investment activities in foreign currency assets, mainly Japanese yen and US dollars. In compliance with Article 2(5) of the ESM Investment Guidelines, currency risk is hedged into euro to ensure a limited remaining foreign exchange risk for the ESM (refer to Note 3.6).

The ESM also conducts funding activities in US dollars. In 2017, the ESM decided to broaden its investor base and spread its funding liquidity risk across the euro and dollar markets. On 31 October 2017, the ESM priced its inaugural US dollar issue, raising $3.0 billion. On 23 October 2018, the ESM raised $3.0 billion by issuing a new 2-year bond, its second deal in the dollar market, followed by a 5-year $2.0 billion bond issuance on 11 September 2019. On 10 September 2020 and 9 September 2021, the ESM raised respectively $3.0 billion and $2.0 billion, and the ESM has hedged the proceeds back into euros (refer to Note 3.6.1.2).

As it is the case for derivatives used to manage interest rate risk, operations contracted with commercial banks are fully collateralised, thanks to the exchange of cash and highly rated securities, regulated by collateral agreements (ISDA and Credit Support Annex).

31 December 2022 (in €'000)	Euro (EUR)	Japanese Yen (JPY)	US Dollar (USD)	Swedish Krone (SEK)	Other currencies	Total
ASSETS						
Cash in hand, balances with central banks and post office banks	55,568,448	-	-	-	-	**55,568,448**
Loans and advances to credit institutions	1,959,738	-	-	-	-	**1,959,738**
Loans and advances to euro area member states	86,210,446	-	-	-	-	**86,210,446**
Debt securities including fixed-income securities	39,112,629	947,210	2,439,824	76,600	450,220	**43,026,483**
Prepayments and accrued income	1,686,760	670	35,625	222	-	**1,723,277**
Total financial assets	**184,538,021**	**947,880**	**2,475,449**	**76,822**	**450,220**	**188,488,392**
LIABILITIES						
Amounts owed to credit institutions	4,969,643	-	-	-	-	**4,969,643**
Debt securities in issue	95,101,010	-	6,551,037	-	-	**101,652,047**
Other liabilities	14,515	-	-	-	-	**14,515**
Accruals and deferred income	1,162,267	10,000	48,560	22	-	**1,220,849**
Total financial liabilities	**101,247,435**	**10,000**	**6,599,597**	**22**	**-**	**107,857,054**
Shareholders' equity[1]	80,634,924	-	-	-	-	**80,634,924**
Total shareholders' equity	**80,634,924**	**-**	**-**	**-**	**-**	**80,634,924**
Off-balance sheet derivatives	**(1,888,180)**	**(954,273)**	**3,851,022**	**(89,914)**	**(503,800)**	**414,855**
Net of financial position	**767,482**	**(16,393)**	**(273,126)**	**(13,114)**	**(53,580)**	**411,269**

[1] Excluding subscribed capital unpaid.

31 December 2021 (in €'000)	Euro (EUR)	Japanese Yen (JPY)	US Dollar (USD)	Swedish Krone (SEK)	Other currencies	Total
ASSETS						
Cash in hand, balances with central banks and post office banks	60,401,825	-	-	-	-	**60,401,825**
Loans and advances to credit institutions	7,098,396	-	-	-	-	**7,098,396**
Loans and advances to euro area member states	89,867,531	-	-	-	-	**89,867,531**
Debt securities including fixed-income securities	33,007,675	4,664,193	5,486,739	266,358	1,013,785	**44,438,750**
Prepayments and accrued income	906,076	2,530	67,568	1,218	-	**977,392**
Total financial assets	**191,281,503**	**4,666,723**	**5,554,307**	**267,576**	**1,013,785**	**202,783,894**
LIABILITIES						
Amounts owed to credit institutions	1,006,032	-	-	-	-	**1,006,032**
Debt securities in issue	108,096,457	-	8,810,094	-	-	**116,906,551**
Other liabilities	9,535	-	-	-	-	**9,535**
Accruals and deferred income	891,375	51,621	75,842	1,269	-	**1,020,107**
Total financial liabilities	**110,003,399**	**51,621**	**8,885,936**	**1,269**	**-**	**118,942,225**
Shareholders' equity[1]	83,846,061	-	-	-	-	**83,846,061**
Total shareholders' equity	**83,846,061**	**-**	**-**	**-**	**-**	**83,846,061**
Off-balance sheet derivatives	**2,291,444**	**(4,614,458)**	**3,358,026**	**(268,285)**	**(1,014,508)**	**(247,781)**
Net of financial position	**(276,513)**	**644**	**26,397**	**(1,978)**	**(723)**	**(252,173)**

[1] Excluding subscribed capital unpaid.

3.4. LIQUIDITY RISK

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

Funding liquidity risk is defined as the risk of loss arising from difficulty in securing the necessary funding, or from a significantly higher cost of funding than normal levels, due to a deterioration of the ESM's creditworthiness, or at a time of unfavourable market conditions (such as periods of high stress). Funding liquidity risk is managed by maintaining permanent market access to a wide investor base with different funding instruments, multiple credit lines and maintaining an adequate liquidity buffer. The market presence in the USD market, which started in 2017, reduces further the funding liquidity risk as it gives access to additional investors in a different market. At the end of December 2022, the ESM's liquidity buffer stood at €18.6 billion (2021: €21.1 billion).

Market liquidity risk is defined as the potential for loss arising from a position that cannot easily be liquidated without significantly and negatively influencing its market price. Market liquidity risk is minimised by investing in high credit quality liquid assets, ensuring the ESM does not hold a significant portion of a security issuance and adopting adequate measurements that allow the timely detection of liquidity deteriorations.

Despite the general context of uncertainty in the global financial markets post COVID-19 pandemic, the war in Ukraine and Central Bank rate normalisation, the ESM continued to maintain a robust liquidity position and diversified access to the necessary liquidity sources, also thanks to its prudent approach to liquidity management.

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

31 December 2022 (in €'000)	Less than 3 months	From 3 months to 1 year	From 1 to 5 years	More than 5 years	Total
ASSETS					
Cash in hand, balances with central banks and post office banks	55,568,448	-	-	-	55,568,448
Loans and advances to credit institutions	1,959,738	-	-	-	1,959,738
Loans and advances to euro area member states	-	-	22,428,717	63,781,729	86,210,446
Debt securities including fixed-income securities	3,197,681	4,373,950	17,712,220	17,742,632	43,026,483
Prepayments and accrued income	1,094,114	627,632	1,413	118	1,723,277
Total financial assets	**61,819,981**	**5,001,582**	**40,142,350**	**81,524,479**	**188,488,392**
LIABILITIES					
Amounts owed to credit institutions	4,969,643	-	-	-	4,969,643
Debt securities in issue	13,124,307	12,730,238	40,977,910	34,819,592	101,652,047
Other liabilities	14,515	-	-	-	14,515
Accruals and deferred income	182,190	537,717	26,492	474,450	1,220,849
Total financial liabilities	**18,290,655**	**13,267,955**	**41,004,402**	**35,294,042**	**107,857,054**
Shareholders' equity(1)	-	-	-	80,634,924	80,634,924
Total shareholders' equity(2)	-	-	-	**80,634,924**	**80,634,924**
Net of financial position	**43,529,326**	**(8,266,373)**	**(862,052)**	**(34,404,487)**	**(3,586)**

(1) Excluding subscribed capital unpaid.
(2) Shareholder equity has no defined maturity.

31 December 2021 (in €'000)	Less than 3 months	From 3 months to 1 year	From 1 to 5 years	More than 5 years	Total
ASSETS					
Cash in hand, balances with central banks and post office banks	60,401,825	-	-	-	**60,401,825**
Loans and advances to credit institutions	7,098,396	-	-	-	**7,098,396**
Loans and advances to euro area member states	-	-	2,215,000	87,652,531	**89,867,531**
Debt securities including fixed-income securities	61,820	2,365,985	13,368,076	28,642,869	**44,438,750**
Prepayments and accrued income	490,759	485,600	118	542	**977,019**
Total financial assets	**68,052,800**	**2,851,585**	**15,583,194**	**116,295,942**	**202,783,521**
LIABILITIES					
Amounts owed to credit institutions	1,006,032	-	-	-	**1,006,032**
Debt securities in issue	16,790,867	19,482,261	41,302,182	39,331,241	**116,906,551**
Other liabilities	9,535	-	-	-	**9,535**
Accruals and deferred income	258,498	427,426	52,290	281,520	**1,019,734**
Total financial liabilities	**18,064,932**	**19,909,687**	**41,354,472**	**39,612,761**	**118,941,852**
Shareholders' equity[1]	-	-	-	83,846,061	**83,846,061**
Total shareholders' equity[2]	**-**	**-**	**-**	**83,846,061**	**83,846,061**
Net of financial position	**49,987,868**	**(17,058,102)**	**(25,771,278)**	**(7,162,880)**	**(4,392)**

[1] Excluding subscribed capital unpaid.
[2] Shareholder equity has no defined maturity.

3.5. OPERATIONAL RISK

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

- execution, delivery, and process management;
- legal and conduct;
- regulatory compliance;
- third party;
- fraud;
- business continuity and technology;
- information security (including Cyber);
- data management;
- people; and
- damage to physical assets.

Management has no tolerance for material operational risks, including those originating from third party/vendor engagements, which may result in the ESM's inability to effectively fulfil its mandate, or in significant loss and/or reputational damage. No material operational risk losses were identified in 2022 or in 2021.

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

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

Since the beginning of the COVID-19 pandemic, the ESM has been working remotely, partially returning to the office during 2021. In 2022, the ESM adopted a permanent hybrid work set-up, where employees were allowed to work partly from the office and partly from home.

3.6. DERIVATIVES

The ESM uses derivative instruments as described in Note 2.6 for risk management purposes as part of its investment and funding activities. In 2015, the ESM entered into foreign exchange derivative transactions, such as foreign exchange swaps and forward contracts to hedge the currency risk related to short-term non-euro denominated investments. Since 2017, the ESM has also entered into interest rate swaps to manage globally the investment portfolio's interest rate exposure and to reduce the risk that Greece would have to pay a higher interest rate on its loans when market rates start rising. Longer-term cross-currency swaps were contracted as well to hedge longer-term non-euro denominated investments and to hedge in euro the issuances in USD.

In 2019, the ESM also started to use bond futures and in 2020 short-term interest rate futures to manage the interest rate risk of the paid-in capital portfolio.

On 31 December 2022, the derivative instruments had a maximum maturity up to 30 years (2021: maximum maturity up to 30 years) and were concluded international financial institutions and commercial banks.

3.6.1. FUNDING-RELATED DERIVATIVES

The derivatives used in the context of funding are:

- Interest rate swaps;
- Cross-currency swaps.

3.6.1.1. INTEREST RATE SWAPS

Interest rate swaps exchange future interest payments, usually a fixed interest rate for a floating rate, or vice versa, to reduce or increase exposure to fluctuations in interest rates based on a specified notional amount.

On 20 January 2017, the ESM Board of Directors approved three schemes aimed at reducing interest rate risk for Greece. Amongst others, it allowed the ESM to enter into interest rate swaps arrangements that aimed to stabilise the ESM's overall cost of funding for Greece, i.e. to reduce the risk that Greece would have to pay a higher interest rate on its loans in case market rates start rising.

The following table shows the interest rate swaps according to their notional amount and fair value. The notional amounts are disclosed off balance sheet.

Interest rate swaps (in €'000)	31.12.2022	31.12.2021
Notional amount	58,222,000	58,710,000
Positive fair value	6,095,718	735,724
Negative fair value	(2,469,718)	(7,261,579)

3.6.1.2. CROSS-CURRENCY SWAPS

Cross-currency swaps are derivative contracts under which two counterparties agree to exchange interest payments (fixed-fixed, fixed-float and float-float) and principal denominated in two different currencies. In a cross-currency swap, interest payments and principal in one currency are exchanged for equally valued principal and interest payments in a different currency. Interest payments are exchanged at fixed intervals during the life of the contract. Starting in 2017, the ESM broadened its investor base and spread its funding liquidity risk across the euro and dollar markets (refer to Note 3.3.2). The ESM hedges the currency risk of these transactions in US dollars using cross-currency swaps contracts.

The following table shows the cross-currency swaps according to their notional amount and fair value. The notional amounts are disclosed off balance sheet.

Cross-currency swaps (in €'000)	31.12.2022	31.12.2021
Notional amount	6,562,910	8,829,242
Positive fair value	470,155	232,434
Negative fair value	-	(17,432)

3.6.2. INVESTMENT-RELATED DERIVATIVES

The derivatives used in the context of investment activity are:

- Interest rate swaps;
- Cross-currency swaps;
- Foreign exchange (FX) swaps;
- Futures contracts.

3.6.2.1. INTEREST RATE SWAPS

Interest rate swaps exchange future interest payments, usually a fixed interest rate for a floating rate, or vice versa, to reduce or increase exposure to fluctuations in interest rates based on a specified notional amount.

Starting in 2017, the ESM has used interest rate swaps to manage the interest rate risk of the paid-in capital portfolio.

The following table shows the interest rate swaps according to their notional amount and fair value. The notional amounts are disclosed off balance sheet.

Interest rate swaps (in €'000)	31.12.2022	31.12.2021
Notional amount	30,108,375	12,855,500
Positive fair value	929,572	99,444
Negative fair value	(861,519)	(156,674)

3.6.2.2. CROSS-CURRENCY SWAPS

Cross-currency swaps are derivatives contracts under which two counterparties agree to exchange interest payments (fixed-fixed, fixed-float and float-float) and principal denominated in two different currencies. In a cross-currency swap, interest payments and principal in one currency are exchanged for equally valued principal and interest payments in a different currency. Interest payments are exchanged at fixed intervals during the life of the contract.

Starting in 2017, the ESM has invested in non-euro denominated securities with longer maturities (above 2 years), using cross-currency swaps to hedge their cash flows in euro.

The following table shows the cross currency swaps according to their notional amount and fair value. The notional amounts are disclosed off balance sheet.

Cross-currency swaps (in €'000)	31.12.2022	31.12.2021
Notional amount	4,072,251	11,237,408
Positive fair value	102,355	100,380
Negative fair value	(232,315)	(302,425)

3.6.2.3. FOREIGN EXCHANGE (FX) SWAPS

In a foreign exchange swap, two parties agree to exchange the principal amounts of two different currencies at the beginning of the transaction and the amounts to exchange at maturity.

The following tables shows the foreign exchange swaps and forwards according to their notional amount. The notional amounts are disclosed off balance sheet.

FX swaps (in €'000)	31.12.2022	31.12.2021
Notional amount	77,289	-
Positive fair value	7,046	-

3.6.2.4. FUTURES CONTRACTS

The ESM also uses futures contracts to manage portfolio interest rate risk by either buying or selling futures contracts.

The following tables show the bond and short-term interest futures contracts according to their notional amount. The notional amounts are disclosed off balance sheet. The fair value of futures contracts is nil at year-end, as the contracts are settled on a daily basis.

Bond futures contracts (in €'000)	31.12.2022	31.12.2021
Notional amount	-	556,500

Interest rate futures contracts (in €'000)	31.12.2022	31.12.2021
Notional amount	-	200,000

3.6.3. CREDIT RISK ON DERIVATIVES

Credit risk exposure for derivatives arises from the potential loss that the ESM would incur if a counterparty were unable to honour its contractual obligations. There are three main forms of credit risk related to derivatives. First, for cross-currency swaps and FX swaps, the exchange of notional principal at the beginning and maturity of a trade can lead to settlement risk. Second, the default of a derivative counterparty over the life of the derivative can lead to a loss, if changes in the mark-to-market (MtM) value of the position are not fully collateralised at the time of default. Third, when using derivatives, the ESM is exposed to replacement risk. This is the loss the ESM would face if it had to replace a trade from a defaulted counterparty with a new counterparty.

With regard to derivative transactions, the ESM has contracted FX and interest rate derivatives since 2015. Operations contracted with commercial banks are fully collateralised, thanks to the exchange of cash and highly rated securities. The exposure after collateral posting is then limited to the intraday market movements and their impact on the market value of the exposure and on the posted collateral value.

The ESM has put in place a series of procedures to safeguard against losses arising from the use of such instruments.

- Contractual framework

All of the ESM's derivatives transactions are governed by best practice International Swaps and Derivatives Association (ISDA) agreements. In addition, for all commercial counterparties, the ESM has put in place Credit Support Annexes (CSAs) for over-the-counter transactions, which specify the conditions of exposure collateralisation on a daily basis.

- Counterparty selection

The minimum rating of a counterparty at the outset of a trade is BBB+/Baa1. The ESM has the right of early termination if the rating of the counterparty drops below a certain level. The ESM sets derivative limits per counterparty, based on forecasted exposure at default. The ESM approach is aligned with the Basel Committee's recommended standardised approach for measuring counterparty credit risk exposures to quantify exposure at default per counterparty. The methodology also considers potential losses that could occur in between the default and the replacement of the cancelled trade.

- Collateralisation

Exposures towards commercial banks (exceeding limited thresholds) are fully collateralised by cash and/or securities. On a daily basis, the ESM monitors and values its derivative positions, and calls or releases collateral, as applicable. Below a certain counterparty credit rating, the ESM receives an additional independent amount from counterparties, in line with recommendations of the Basel Committee.

- Settlement limits

The ESM limits settlement risk for bilateral FX swaps and cross-currency swaps through settlement limits for counterparties, based on these counterparties' creditworthiness. Settlement risk is measured and monitored on a daily basis.

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

The composition of cash in hand, balances with central banks and post office banks is as follows:

(in €'000)	31.12.2022	31.12.2021
Current account balances with euro area central banks[1]	55,564,825	60,395,136
Current account balances with other banks[2]	3,623	6,689
Total cash in hand, balances with central banks and post office banks	**55,568,448**	**60,401,825**

[1] During the financial year, the ESM held balances with national central banks from France (Banque de France), Germany (Deutsche Bundesbank), Italy (Banca d'Italia) and the Netherlands (De Nederlandsche Bank), as well as with the European Central Bank.
[2] The ESM holds current accounts for operational purposes with a state-owned bank as well as clearing accounts with custodians. No current account is held with post office banks.

The cash balance with euro area central banks is comprised of paid-in capital, the reserve fund, the other reserves, and the liquidity buffer investment.

5. Loans and advances to credit institutions

The following table shows the breakdown of the other loans and advances to credit institutions:

(in €'000)	31.12.2022	31.12.2021
Reverse repos	1,156,989	949,799
Money market deposits with other banks	550,000	-
Cash collateral provided	251,030	6,146,994
Other deposits	1,719	1,603
Total loans and advances to credit institutions	**1,959,738**	**7,098,396**

Other deposits consist entirely of the lease guarantee deposit in relation to the ESM rental agreement. The cash collateral provided relates entirely to derivatives transactions. The reverse repurchase agreements ('reverse repos') are centrally cleared transactions on regulated markets.

6. Loans and advances to euro area member states

In accordance with Article 13 of the ESM Treaty, the Board of Governors may decide to grant financial assistance including in the form of a loan to an ESM Member (refer to Note 26).

The following table shows the geographical breakdown of loans per financial assistance programme and by borrowing country:

(in €'000)	No. of loans	Nominal amount	Clean carrying value as at 31 December 2022
Loans to euro area member states			
- to Spain	5	20,078,717	20,078,717
- to Cyprus	9	6,300,000	6,300,000
- to Greece	11	59,831,729	59,831,729
Total	**25**	**86,210,446**	**86,210,446**

(in €'000)	No. of loans	Nominal amount	Clean carrying value as at 31 December 2021
Loans to euro area member states			
- to Spain	5	23,721,460	23,721,460
- to Cyprus	9	6,300,000	6,300,000
- to Greece	11	59,846,071	59,846,071
Total	**25**	**89,867,531**	**89,867,531**

The following table shows the movements of the loans to euro area member states during 2021 and 2022:

(in €'000)	
1 January 2021 balance	**89,894,688**
New disbursements	-
Early repayments	(27,157)
- from Greece	*(27,157)*
31 December 2021 balance	**89,867,531**
(in €'000)	

1 January 2022 balance	89,867,531
New disbursements	-
Scheduled repayments	(3,642,743)
- from Spain	*(3,642,743)*
Early repayments	(14,342)
- from Greece	*(14,342)*
31 December 2022 balance	**86,210,446**

During 2022, the ESM risk assessment and impairment assessment methodology duly captured (via its Early Warning System) the severe impact from the war in Ukraine, which caused an increase in energy prices and commodity that lead to an acceleration of inflation and a slowdown in economic growth. In particular, the assessment focused on whether the effects of the war triggered a significant increase in credit risk and if it would materialise potential impairment. In that context, a complete assessment of a wide range of inputs based on forward-looking information was performed, to ensure a comprehensive assessment of all short-term and medium-to-long term factors and consequences. As described above, inputs include short-term economic data, vulnerability indicators, liquidity balances and market indicators, together with medium-to-long term risks, policy measures and mitigating factors.

Such assessment returned the outcome that, as of 31 December 2022, the overall credit quality of the ESM loans portfolio remained stable.

7. Debt securities including fixed-income securities

The following table shows the details of the paid-in-capital portfolio debt securities valuation:

31.12.2022 (in €'000)	Amortised cost	Unrealised gains	Carrying amount	Nominal amount
Short-term, medium-term, and long-term tranche	35,135,921	(3,195,683)	31,940,238	35,173,351
Hold-to-maturity tranche	11,086,245	-	11,086,245	10,825,230
Total debt securities including fixed income securities	**46,222,166**	**(3,195,683)**	**43,026,483**	**45,998,581**

31.12.2021 (in €'000)	Amortised cost	Unrealised gains	Carrying amount	Nominal amount
Short-term, medium-term, and long-term tranche	34,580,515	(44,749)	34,535,766	34,373,801
Hold-to-maturity tranche	9,902,984	-	9,902,984	9,598,630
Total debt securities including fixed income securities	**44,483,499**	**(44,749)**	**44,438,750**	**43,972,431**

On 31 December 2022, the amortised cost of the debt securities invested in the Short-term tranche and in the Medium and long-term tranche was €35.1 billion (31 December 2021: €34.6 billion), against a carrying amount at fair value of €31.9 billion (31 December 2021: €34.5 billion). The difference represents the unrealised result and is recognised directly in the equity within the fair value reserve.

The debt securities invested in the Hold-to-maturity tranche are initially recognised at cost and measured subsequently at amortised cost (refer to Note 2.8.1), less impairment where needed.

On 31 December 2022, the total carrying amount of the debt securities in the paid-in capital portfolios was €43.0 billion (31 December 2021: €44.4 billion).

In respect of the paid-in capital portfolio invested in debt securities, the ESM has an established investment policy setting strict eligibility criteria that restrict investment to issuers with the highest credit quality. The ESM's risk management defines a limit structure to mitigate the maximum exposure per issuer.

On 31 December 2022, the debt securities including fixed income securities included also investments in money market securities that were not listed on regulated markets with a total carrying value of €218.8 million (31 December

2021: €149.5 million). Their fair values were determined using valuation techniques, as disclosed in Note 2.8.3. All other securities were listed on regulated markets and the fair values of these assets are based on quoted market prices.

The ESM invests in debt securities issued by public bodies and other issuers. Public bodies include central banks, central governments, regional governments, local governments, supranational institutions and governmental agencies. On 31 December 2022, debt securities issued by public bodies amounted to €31.9 billion (31 December 2021: €21.7 billion), while debt securities issued by other borrowers amounted to €11.1 billion (31 December 2021: €22.7 billion).

Starting from 2015, the ESM has invested part of the paid-in capital portfolio in short-term assets denominated in a foreign currency (refer to Note 3.3.2). Starting in 2017, the ESM has invested in non-euro denominated securities with longer maturities.

8. Intangible assets

The following table shows the movements of intangible assets during 2022:

(in €'000)	Software	Total intangible assets
Historical cost		
1 January 2022 balance	235	235
Additions	185	185
31 December 2022 balance	**420**	**420**
Accumulated amortisation		
1 January 2022 balance	(212)	(212)
Amortisation	(59)	(59)
31 December 2022 balance	**(271)**	**(271)**
Net book value		
31 December 2022 balance	**149**	**149**
31 December 2021 balance	**23**	**23**

9. Tangible assets

The following table shows the movements of tangible assets during 2022:

(in €'000)	Fixtures and fittings	Furniture and office equipment	Total tangible assets
Historical cost			
1 January 2022 balance	10,971	3,601	14,572
Additions	144	405	549
31 December 2022 balance	**11,115**	**4,006**	**15,121**
Accumulated depreciation			
1 January 2022 balance	(7,462)	(2,741)	(10,203)
Depreciation	(1,088)	(393)	(1,481)
31 December 2022 balance	**(8,550)**	**(3,134)**	**(11,684)**
Net book value			
31 December 2022 balance	**2,565**	**872**	**3,437**
31 December 2021 balance	**3,509**	**860**	**4,369**

10. Prepayments and accrued income

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

(in €'000)	31.12.2022	31.12.2021
Interest receivable on:		
- Cash and cash equivalents	68,319	-
- Debt securities including fixed-income securities	99,622	91,697
- Loans and advances to euro area member states	366,390	346,496
- Loans and advances to credit institutions	1,744	404
Amounts charged to the EFSF for administrative services (Notes 20/26)	8,300	8,311
Prepayments	4,330	1,854
Prepayments and accrued income on derivatives[1]	1,174,572	528,630
Total prepayments and accrued income	**1,723,277**	**977,392**

[1] "Prepayments and accrued income on derivatives" represents the spot revaluation, spread amortisation and accrued income of ongoing derivative transactions (refer to Note 2.12).

11. Amounts owed to credit institutions

On 31 December 2022, the €5.0 billion (31 December 2021: €1.0 billion) of amounts owed to credit institutions were composed of cash collateral received for the derivatives €3.8 billion (31 December 2021: €55.8 million) and repurchase agreements ("repo") €1.2 billion (31 December 2021: €950.2 million).

12. Debts evidenced by certificates

The following table discloses the details of debt securities in issue outstanding on 31 December 2022, together with the coupon rates and due dates.

Type of funding programmes	ISIN code	Nominal amount (in €'000)	Issue date	Maturity date	Coupon
Long-term Funding	EU000A1U9803	3,000,000	20/11/2013	20/11/2023	2.125%
Long-term Funding	EU000A1U9803[2]	990,750	27/06/2014	20/11/2023	2.125%
Long-term Funding	EU000A1U9894	3,000,000	23/09/2015	23/09/2025	1.000%
Long-term Funding	EU000A1U9894[2]	999,850	29/09/2016	23/09/2025	1.000%
Long-term Funding	EU000A1U9894[2]	2,000,000	27/09/2022	23/09/2025	1.000%
Long-term Funding	EU000A1Z99Q7	2,000,000	23/05/2022	23/06/2027	1.000%
Long-term Funding	EU000A1Z99Q7[2]	2,000,000	24/10/2022	23/06/2027	1.000%
Long-term Funding	EU000A1U9902	3,000,000	20/10/2015	20/10/2045	N/A
Long-term Funding	EU000A1U9928	1,500,000	17/11/2015	17/11/2036	1.625%
Long-term Funding	EU000A1U9928[2]	1,000,000	31/03/2016	17/11/2036	1.625%
Long-term Funding	EU000A1U9936	1,000,000	01/12/2015	01/12/2055	1.850%
Long-term Funding	EU000A1U9936[2]	1,000,000	01/03/2016	01/12/2055	1.850%
Long-term Funding	EU000A1U9936[2]	750,000	05/09/2018	01/12/2055	1.850%
Long-term Funding	EU000A1U9944	3,000,000	02/03/2016	02/03/2026	0.500%
Long-term Funding	EU000A1U9944[2]	2,500,000	19/07/2016	02/03/2026	0.500%
Long-term Funding	EU000A1U9951	3,000,000	22/04/2016	22/04/2024	0.125%
Long-term Funding	EU000A1U9951[2]	961,100	28/07/2016	22/04/2024	0.125%
Long-term Funding	EU000A1U9951[2]	989,750	11/11/2016	22/04/2024	0.125%
Long-term Funding	EU000A1U9969	3,000,000	03/05/2016	03/05/2032	1.125%
Long-term Funding	EU000A1U9969[2]	1,000,000	18/10/2016	03/05/2032	1.125%
Long-term Funding	EU000A1U9977	2,500,000	19/07/2016	18/07/2042	0.875%
Long-term Funding	EU000A1Z99A1	3,500,000	01/02/2017	02/11/2046	1.800%
Long-term Funding	EU000A1Z99A1[2]	1,500,000	14/06/2017	02/11/2046	1.800%
Long-term Funding	EU000A1Z99B9	3,000,000	14/03/2017	15/03/2027	0.750%
Long-term Funding	EU000A1Z99B9[2]	1,500,000	19/06/2018	15/03/2027	0.750%
Long-term Funding	EU000A1Z99D5	2,000,000	23/05/2018	23/05/2033	1.200%

Continued from the previous page

Type of funding programmes	ISIN code	Nominal amount (in €'000)	Issue date	Maturity date	Coupon
Long-term Funding	EU000A1Z99E3	4,000,000	31/07/2018	31/07/2023	0.100%
Long-term Funding	EU000A1Z99F0	3,250,000	05/09/2018	05/09/2028	0.750%
Long-term Funding	EU000A1Z99F0(2)	1,500,000	05/09/2018	05/09/2028	0.750%
Long-term Funding	EU000A1Z99H6	2,000,000	05/03/2019	05/03/2029	0.500%
Long-term Funding	EU000A1Z99H6(2)	1,000,000	14/05/2019	05/03/2029	0.500%
Long-term Funding	EU000A1Z99J2(1)	3,500,000	29/10/2019	14/03/2025	N/A
Long-term Funding	EU000A1Z99K0	3,000,000	17/02/2020	10/02/2023	N/A
Long-term Funding	EU000A1Z99L8	2,000,000	04/03/2020	04/03/2030	0.010%
Long-term Funding	EU000A1Z99M6	2,000,000	26/10/2020	16/12/2024	N/A
Long-term Funding	EU000A1Z99M6(2)	2,000,000	11/10/2021	16/12/2024	N/A
Long-term Funding	EU000A1Z99N4	2,000,000	15/03/2021	15/12/2026	N/A
Long-term Funding	EU000A1Z99N4(2)	2,000,000	23/02/2022	15/12/2026	N/A
Long-term Funding	EU000A1Z99P9	2,000,000	04/05/2021	15/10/2031	0.010%
Long-term Funding	XS2051117195(4)	1,875,117	11/09/2019	11/09/2024	1.375%
Long-term Funding	XS2226989015(4)	2,812,675	10/09/2020	10/09/2025	0.375%
Long-term Funding	XS2384361684(4)	1,875,117	09/09/2021	08/09/2023	0.250%
Long-term Funding	ESMNBOND0001(3)	80,000	22/01/2016	22/01/2041	1.572%
Long-term Funding	ESMNBOND0002(3)	30,000	10/02/2016	11/02/2041	1.360%
Long-term Funding	ESMNBOND0003(3)	25,000	09/03/2016	09/03/2056	1.559%
Long-term Funding	ESMNBOND0004(3)	25,000	09/03/2016	09/03/2056	1.559%
Long-term Funding	ESMNBOND0005(3)	25,000	31/03/2016	22/03/2046	1.316%
Long-term Funding	ESMNBOND0006(3)	30,000	11/04/2016	11/04/2046	1.220%
Long-term Funding	ESMNBOND0007(3)	40,000	03/08/2016	03/08/2056	1.156%
Long-term Funding	ESMNBOND0008(3)	150,000	09/08/2016	09/08/2056	1.150%
Long-term Funding	ESMNBOND0009(3)	50,000	19/08/2016	19/08/2053	1.025%
Long-term Funding	ESMNBOND0010(3)	50,000	19/08/2016	18/08/2056	1.064%
Long-term Funding	ESMNBOND0011(3)	50,000	19/09/2016	19/09/2051	1.030%
Long-term Funding	ESMNBOND0012(3)	50,000	19/10/2016	19/10/2054	1.145%
Long-term Funding	ESMNBOND0013(3)	40,000	19/10/2016	19/10/2056	1.125%
Long-term Funding	ESMNBOND0014(3)	25,000	27/10/2016	27/10/2056	1.086%
Long-term Funding	ESMNBOND0015(3)	110,000	14/03/2017	14/03/2047	1.800%
Long-term Funding	ESMNBOND0016(3)	40,000	31/03/2017	30/03/2057	1.850%
Long-term Funding	ESMNBOND0017(3)	100,000	21/04/2017	21/04/2047	1.573%
Long-term Funding	ESMNBOND0018(3)	60,000	27/11/2017	27/11/2057	1.591%
Long-term Funding	ESMNBOND0019(3)	25,000	11/12/2017	11/12/2057	1.530%
Long-term Funding	ESMNBOND0020(3)	50,000	12/12/2017	12/12/2057	1.505%
Long-term Funding	ESMNBOND0021(3)	50,000	19/12/2017	19/12/2057	1.442%
Short-term Funding	EU000A3JZRR2(1)	1,072,710	08/12/2022	09/03/2023	N/A
Short-term Funding	EU000A3JZRQ4(1)	1,011,400	17/11/2022	18/05/2023	N/A
Short-term Funding	EU000A3JZRP6(1)	1,015,300	04/11/2022	09/02/2023	N/A
Short-term Funding	EU000A3JZRN1(1)	1,011,160	20/10/2022	20/04/2023	N/A
Short-term Funding	EU000A3JZRM3(1)	1,499,760	06/10/2022	05/01/2023	N/A
Short-term Funding	EU000A3JZRL5(1)	1,093,250	22/09/2022	23/03/2023	N/A
Short-term Funding	EU000A3JZRJ9(1)	1,097,150	18/08/2022	23/02/2023	N/A
Short-term Funding	EU000A3JZRG5(1)	1,100,000	21/07/2022	19/01/2023	N/A
Short-term Funding	EU000A3JZQ93(1)	854,800	14/04/2022	13/04/2023	N/A
Short-term Funding	EU000A3JZQ69(1)	1,099,850	10/03/2022	16/03/2023	N/A
Short-term Funding	EU000A3JZQ36(1)	1,058,600	10/02/2022	16/02/2023	N/A
Short-term Funding	EU000A3JZQ02(1)	1,093,550	13/01/2022	12/01/2023	N/A
Total(5)		**101,616,889**			

(1) Zero-coupon bond.
(2) Tap issue.
(3) N-bond with technical ISIN: the ESM issued its first N-bond (Namensschuldverschreibungen) in 2016. N-Bonds are privately placed, long-term funding instruments that are neither centrally cleared nor listed.
(4) USD denominated debt securities issued starting from 2017.
(5) The difference with the total amount in the balance sheet comes from the premium and discount amortisations. The debts evidenced by certificates are presented at their amortised cost in balance sheet (Refer to Note 2.14).

The following table discloses the details of debt securities in issue outstanding on 31 December 2021, together with the coupon rates and due dates.

Type of funding programmes	ISIN code	Nominal amount (in €'000)	Issue date	Maturity date	Coupon
Long-term Funding	EU000A1U9803	3,000,000	20/11/2013	20/11/2023	2.125%
Long-term Funding	EU000A1U9803(2)	990,750	27/06/2014	20/11/2023	2.125%
Long-term Funding	EU000A1U9894	3,000,000	23/09/2015	23/09/2025	1.000%
Long-term Funding	EU000A1U9894(2)	999,850	29/09/2016	23/09/2025	1.000%
Long-term Funding	EU000A1U9902	3,000,000	20/10/2015	20/10/2045	1.750%
Long-term Funding	EU000A1U9928	1,500,000	17/11/2015	17/11/2036	1.625%
Long-term Funding	EU000A1U9928(2)	1,000,000	31/03/2016	17/11/2036	1.625%
Long-term Funding	EU000A1U9936	1,000,000	01/12/2015	01/12/2055	1.850%
Long-term Funding	EU000A1U9936(2)	1,000,000	01/03/2016	01/12/2055	1.850%
Long-term Funding	EU000A1U9936(2)	750,000	05/09/2018	01/12/2055	1.850%
Long-term Funding	EU000A1U9944	3,000,000	02/03/2016	02/03/2026	0.500%
Long-term Funding	EU000A1U9944(2)	2,500,000	19/07/2016	02/03/2026	0.500%
Long-term Funding	EU000A1U9951	3,000,000	22/04/2016	22/04/2024	0.125%
Long-term Funding	EU000A1U9951(2)	961,100	28/07/2016	22/04/2024	0.125%
Long-term Funding	EU000A1U9951(2)	989,750	11/11/2016	22/04/2024	0.125%
Long-term Funding	EU000A1U9969	3,000,000	03/05/2016	03/05/2032	1.125%
Long-term Funding	EU000A1U9969(2)	1,000,000	18/10/2016	03/05/2032	1.125%
Long-term Funding	EU000A1U9977	2,500,000	19/07/2016	18/07/2042	0.875%
Long-term Funding	EU000A1U9985(1)	3,000,000	18/10/2016	18/10/2022	N/A
Long-term Funding	EU000A1U9985(2)	996,500	16/11/2017	18/10/2022	N/A
Long-term Funding	EU000A1U9985(2)	998,550	23/02/2018	18/10/2022	N/A
Long-term Funding	EU000A1Z99A1	3,500,000	01/02/2017	02/11/2046	1.800%
Long-term Funding	EU000A1Z99A1(2)	1,500,000	14/06/2017	02/11/2046	1.800%
Long-term Funding	EU000A1Z99B9	3,000,000	14/03/2017	15/03/2027	0.750%
Long-term Funding	EU000A1Z99B9(2)	1,500,000	19/06/2018	15/03/2027	0.750%
Long-term Funding	EU000A1Z99D5	2,000,000	23/05/2018	23/05/2033	1.200%
Long-term Funding	EU000A1Z99E3	4,000,000	31/07/2018	31/07/2023	0.100%
Long-term Funding	EU000A1Z99F0	3,250,000	05/09/2018	05/09/2028	0.750%
Long-term Funding	EU000A1Z99F0(2)	1,500,000	05/09/2018	05/09/2028	0.750%
Short-term Funding	EU000A1Z99G8	1,500,000	14/05/2019	17/01/2022	N/A
Long-term Funding	EU000A1Z99G8(2)	3,000,000	16/10/2018	17/01/2022	N/A
Long-term Funding	EU000A1Z99H6	2,000,000	05/03/2019	05/03/2029	0.500%
Long-term Funding	EU000A1Z99H6(2)	1,000,000	14/05/2019	05/03/2029	0.500%
Long-term Funding	EU000A1Z99J2(1)	3,500,000	29/10/2019	14/03/2025	N/A
Long-term Funding	EU000A1Z99K0	3,000,000	17/02/2020	10/02/2023	N/A
Long-term Funding	EU000A1Z99L8	2,000,000	04/03/2020	04/03/2030	0.010%
Long-term Funding	EU000A1Z99M6	2,000,000	26/10/2020	16/12/2024	N/A
Long-term Funding	EU000A1Z99M6(2)	2,000,000	11/10/2021	16/12/2024	N/A
Long-term Funding	EU000A1Z99N4	2,000,000	15/03/2021	15/12/2026	N/A
Long-term Funding	EU000A1Z99P9	2,000,000	04/05/2021	15/10/2031	0.010%
Long-term Funding	XS1704649158(4)	2,648,773	31/10/2017	03/11/2022	2.125%
Long-term Funding	XS2051117195(4)	1,765,848	11/09/2019	11/09/2024	1.375%
Long-term Funding	XS2226989015(4)	2,648,773	10/09/2020	10/09/2025	0.375%
Long-term Funding	XS2384361684(4)	1,765,848	09/09/2021	08/09/2023	0.250%
Long-term Funding	ESMNBOND0001(3)	80,000	22/01/2016	22/01/2041	1.572%
Long-term Funding	ESMNBOND0002(3)	30,000	10/02/2016	11/02/2041	1.360%
Long-term Funding	ESMNBOND0003(3)	25,000	09/03/2016	09/03/2056	1.559%

Continued from the previous page

Type of funding programmes	ISIN code	Nominal amount (in €'000)	Issue date	Maturity date	Coupon
Long-term Funding	ESMNBOND0004[3]	25,000	09/03/2016	09/03/2056	1.559%
Long-term Funding	ESMNBOND0005[3]	25,000	31/03/2016	22/03/2046	1.316%
Long-term Funding	ESMNBOND0006[3]	30,000	11/04/2016	11/04/2046	1.220%
Long-term Funding	ESMNBOND0007[3]	40,000	03/08/2016	03/08/2056	1.156%
Long-term Funding	ESMNBOND0008[3]	150,000	09/08/2016	09/08/2056	1.150%
Long-term Funding	ESMNBOND0009[3]	50,000	19/08/2016	19/08/2053	1.025%
Long-term Funding	ESMNBOND0010[3]	50,000	19/08/2016	18/08/2056	1.064%
Long-term Funding	ESMNBOND0011[3]	50,000	19/09/2016	19/09/2051	1.030%
Long-term Funding	ESMNBOND0012[3]	50,000	19/10/2016	19/10/2054	1.145%
Long-term Funding	ESMNBOND0013[3]	40,000	19/10/2016	19/10/2056	1.125%
Long-term Funding	ESMNBOND0014[3]	25,000	27/10/2016	27/10/2056	1.086%
Long-term Funding	ESMNBOND0015[3]	110,000	14/03/2017	14/03/2047	1.800%
Long-term Funding	ESMNBOND0016[3]	40,000	31/03/2017	30/03/2057	1.850%
Long-term Funding	ESMNBOND0017[3]	100,000	21/04/2017	21/04/2047	1.573%
Long-term Funding	ESMNBOND0018[3]	60,000	27/11/2017	27/11/2057	1.591%
Long-term Funding	ESMNBOND0019[3]	25,000	11/12/2017	11/12/2057	1.530%
Long-term Funding	ESMNBOND0020[3]	50,000	12/12/2017	12/12/2057	1.505%
Long-term Funding	ESMNBOND0021[3]	50,000	19/12/2017	19/12/2057	1.442%
Short-term Funding	EU000A2SB992[1]	1,099,360	14/01/2021	13/01/2022	N/A
Short-term Funding	EU000A3JZP37[1]	1,091,000	11/02/2021	10/02/2022	N/A
Short-term Funding	EU000A3JZP60[1]	1,099,900	11/03/2021	10/03/2022	N/A
Short-term Funding	EU000A3JZP94[1]	1,100,000	15/04/2021	14/04/2022	N/A
Short-term Funding	EU000A3JZQC6[1]	1,099,620	13/05/2021	12/05/2022	N/A
Short-term Funding	EU000A3JZQF9[1]	1,100,000	10/06/2021	16/06/2022	N/A
Short-term Funding	EU000A3JZQJ1[1]	1,099,330	15/07/2021	14/07/2022	N/A
Short-term Funding	EU000A3JZQK9[1]	1,492,100	22/07/2021	20/01/2022	N/A
Short-term Funding	EU000A3JZQM5[1]	1,099,850	12/08/2021	11/08/2022	N/A
Short-term Funding	EU000A3JZQN3[1]	1,499,450	19/08/2021	17/02/2022	N/A
Short-term Funding	EU000A3JZQQ6[1]	1,099,960	16/09/2021	15/09/2022	N/A
Short-term Funding	EU000A3JZQR4[1]	1,500,000	23/09/2021	17/03/2022	N/A
Short-term Funding	EU000A3JZQS2[1]	1,499,740	07/10/2021	06/01/2022	N/A
Short-term Funding	EU000A3JZQT0[1]	1,098,400	14/10/2021	13/10/2022	N/A
Short-term Funding	EU000A3JZQU8[1]	1,499,250	21/10/2021	21/04/2022	N/A
Short-term Funding	EU000A3JZQV6[1]	1,499,580	04/11/2021	03/02/2022	N/A
Short-term Funding	EU000A3JZQW4[1]	1,099,560	11/11/2021	10/11/2022	N/A
Short-term Funding	EU000A3JZQX2[1]	1,499,920	18/11/2021	19/05/2022	N/A
Short-term Funding	EU000A3JZQY0[1]	1,500,000	09/12/2021	03/03/2022	N/A
Total[5]		116,447,762			

[1] Zero-coupon bond.
[2] Tap issue.
[3] N-bond with technical ISIN: the ESM issued its first N-bond (Namensschuldverschreibungen) in 2016. N-Bonds are privately placed, long-term funding instruments that are neither centrally cleared nor listed.
[4] USD denominated debt securities issued starting from 2017.
[5] The difference with the total amount in the balance sheet comes from the premium and discount amortisations. The debts evidenced by certificates are presented at their amortised cost in balance sheet (Refer to Note 2.14).

The following table shows the movements of the debt securities in issue in 2021 and 2022:

(in €'000)	
1 January 2021 balance	**117,511,345**
Issuance during the period	54,480,809
Maturities during the year	(55,459,930)
Exchange adjustments	617,510
Premiums/discounts amortisation	(243,183)
31 December 2021 balance	**116,906,551**

(in €'000)	
1 January 2022 balance	**116,906,551**
Issuances during the year	38,302,830
Maturities during the year	(53,971,483)
Exchange adjustments	541,016
Premiums/discounts amortisation	(126,867)
31 December 2022 balance	**101,652,047**

Debt securities issued in or after October 2019 were issued under Luxembourg law as the governing law. Debt securities issued before October 2019 and tapped after this date remain under English law. N-bonds are always issued under German law, and United States dollar-denominated debt securities are always issued under English law.

13. Other liabilities

On 31 December 2022, the other liabilities were composed of suppliers' invoices and staff cost related payables not yet settled, amounting to €14.5 million (31 December 2021: €9.5 million).

14. Accruals and deferred income

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

(in €'000)	31.12.2022	31.12.2021
Interest payable on cash and cash equivalents	-	25,638
Interest payable on loans to credit institutions	4,557	4,011
Interest payable on debts evidenced by certificates	240,563	219,065
Deferred income on up-front service fee	52,210	92,984
Accruals and deferred income on derivatives[(1)]	923,519	678,409
Total accruals and deferred income	**1,220,849**	**1,020,107**

[(1)] "Accruals and deferred income on derivatives" represents the spot revaluation, spread amortisation and accrued expense of ongoing derivative transactions (refer to Note 2.17 and 2.6).

As explained in Note 2.4, the amortisation of the up-front service fee is recognised in the profit and loss account on a linear basis under 'Interest receivable and similar income on loans to euro area member states'.

15. Subscribed capital

(in €'000)	Subscribed capital	Subscribed, uncalled capital	Subscribed, called capital
1 January 2021	704,798,700	(624,250,300)	80,548,400
Subscription to the authorised capital	-	-	-
Authorised capital calls	-	-	-
31 December 2021	704,798,700	(624,250,300)	80,548,400

(in €'000)	Subscribed capital	Subscribed, uncalled capital	Subscribed, called capital
1 January 2022	704,798,700	(624,250,300)	80,548,400
Subscription to the authorised capital	-	-	-
Authorised capital calls	-	-	-
31 December 2022	704,798,700	(624,250,300)	80,548,400

On 31 December 2022, the ESM's shareholders were the 19 euro area member states. The contribution key for subscribing to the ESM authorised capital is based on the key for subscription, by the national central banks of the ESM Members, of the ECB's capital.

Latvia joined the ESM on 13 March 2014 and subscribed to an authorised capital of 19,353 shares with a par value of €100,000 each, representing €1.9 billion of subscribed capital of which €221.2 million was called. On 31 December 2018 Latvia had completed all instalments for the payment of paid-in shares. Lithuania joined the ESM on 3 February 2015 and subscribed to an authorised capital of 28,634 shares with a par value of €100,000 each, representing €2.9 billion of subscribed capital, of which €327.2 million was called. On 31 December 2019 Lithuania had completed all instalments for the payment of paid-in shares.

On 31 December 2022, the authorised capital was €704.8 billion (31 December 2021: €704.8 billion), divided into 7,047,987 shares (31 December 2021: 7,047,987 shares), with a par value of €100,000 each, and is split according to the contribution key. Out of the total authorised capital, €624.3 billion (31 December 2021: €624.3 billion) is callable. On 31 December 2022, the total called subscribed capital amounted to €80.5 billion is paid (31 December 2021: €80.5 billion).

ESM Members 31 December 2022	ESM Key (%)	Number of shares	Subscribed capital (in €'000)	Subscribed capital called and paid (in €'000)
Federal Republic of Germany	26.8992	1,895,854	189,585,400	21,666,900
French Republic	20.2003	1,423,716	142,371,600	16,271,040
Italian Republic	17.7506	1,251,062	125,106,200	14,297,850
Kingdom of Spain	11.7953	831,332	83,133,200	9,500,940
Kingdom of The Netherlands	5.6650	399,267	39,926,700	4,563,050
Kingdom of Belgium	3.4454	242,832	24,283,200	2,775,220
Hellenic Republic	2.7910	196,710	19,671,000	2,248,110
Republic of Austria	2.7581	194,388	19,438,800	2,221,580
Portuguese Republic	2.4863	175,236	17,523,600	2,002,700
Republic of Finland	1.7811	125,531	12,553,100	1,434,640
Ireland	1.5777	111,195	11,119,500	1,270,800
Slovak Republic	0.9849	69,418	6,941,800	793,350
Republic of Slovenia	0.4670	32,917	3,291,700	376,190
Republic of Lithuania	0.4063	28,634	2,863,400	327,200
Republic of Latvia	0.2746	19,353	1,935,300	221,200
Grand Duchy of Luxembourg	0.2482	17,490	1,749,000	199,890
Republic of Cyprus	0.1945	13,705	1,370,500	156,630
Republic of Estonia	0.1847	13,020	1,302,000	148,800
Republic of Malta	0.0898	6,327	632,700	72,310
Total	100.00	7,047,987	704,798,700	80,548,400

There are three different instances when a capital call can be made, in accordance with Article 9 of the ESM Treaty.

- A general capital call under Article 9(1) of the ESM Treaty concerns payment of the initial capital and an increase of paid-in capital that could be necessary, for example, to raise the lending capacity. To initiate such a call, the Managing Director of the ESM would make a proposal to the Board of Governors outlining the objective of such a call, the amounts and contributions for each ESM members, and a proposed payment schedule. The Board of Governors, by mutual agreement, may call in authorised capital at any time.

- A capital call under Article 9(2) of the ESM Treaty to replenish the paid-in capital could happen for two reasons:

  - to cover a shortfall due to a non-payment by a beneficiary country and/or,

  - if losses occurring due to other factors reduce the countervalue of the paid-in capital below the threshold of 15% of the maximum lending volume of the ESM.

  The Managing Director would make a proposal to the Board of Directors, which would specify the losses incurred and the underlying reasons. A simple majority of the Board of Directors is required to agree to call in capital under these circumstances.

- An emergency capital call, under Article 9(3) of the ESM Treaty to avoid default of an ESM payment obligation to its creditors.

  The Managing Director has responsibility for making such a capital call to ESM Members if there were a risk of default. As stated in the ESM Treaty, the ESM Members have irrevocably and unconditionally undertaken to pay on demand such capital within seven days of receipt of the demand.

If an ESM Member fails to meet the required payment under a capital call made pursuant to Article 9(2) or (3) of the ESM Treaty, a revised increased capital call would be made to all ESM Members by increasing the contribution rate of the remaining ESM Members on a pro-rata basis, according to Article 25 (2) of the ESM Treaty. When the ESM Member that failed to contribute settles its debt to the ESM, the excess capital is returned to the other ESM Members.

16. Reserve fund and other reserves

As foreseen by Article 24 of the ESM Treaty, the Board of Governors shall establish a reserve fund and, where appropriate, other funds. Without prejudice to the distribution of dividends pursuant to Article 23 of the ESM Treaty, the net income generated by the ESM's operations and the proceeds of possible financial sanctions received from ESM Members under the multilateral surveillance procedure, the excessive deficit procedure and the macroeconomic imbalances procedure established under the Treaty on the Functioning of the European Union (TFEU) are put aside in a reserve fund, in accordance with Article 24(2) of the ESM Treaty. The primary purpose of the reserve fund is the absorption of potential losses.

On 16 June 2022, the Board of Governors decided at its annual general meeting to appropriate the net result for 2021, amounting to €311.0 million, to the reserve fund for an amount of €205.0 million and to the other reserves for an amount of €106.0 million (refer to Note 2.18). As a result, the outstanding balance of the reserve fund as at 31 December 2022 is €3.2 billion (31 December 2021: €3.0 billion) and the outstanding balance of the other reserves is €106.0 million (€ nil as at 31 December 2021).

17. Interest receivable and similar income on loans and advances to euro area member states

Interest receivable and similar income on loans and advances to euro area member states are detailed as follows:

(in €'000)	2022	2021
Interest on loans [(1)]	976,992	956,277
Amortisation up-front service fee	40,773	45,120
Total interest and similar income	**1,017,765**	**1,001,397**

[(1)] The interest on loans comprises base rate interest representing the cost of funding of the ESM, the margin and the annual service fee as the ESM Pricing Policy defines them.

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

The geographical breakdown of the interest receivable and similar income on debt securities including fixed-income securities is detailed as follows:

(in €'000)	2022	2021
Euro area issuers	82,760	34,768
Other EU issuers	5,016	4,156
EU supranational organisations	17,219	17,907
Total European Union	**104,995**	**56,831**
Other non-EU issuers	71,058	38,821
Other supranational organisations	19,982	36,632
Total outside the European Union	**91,040**	**75,453**
Total interest and similar income(1)	**196,035**	**132,284**

(1) As detailed under 2.2, the calculation method for results on debt securities including fixed income securities was changed in 2021 from FIFO to AVCO. If the FIFO method had been applied throughout 2021, the net interest result would have been €131,783 thousand.

19. Interest receivable/payable and similar income/charges on cash and cash equivalents

On 31 December 2022, the interest receivable and similar income as well as interest payable and similar charges on cash and cash equivalents represent interest received and paid for the balances with central banks and amounts to €150.4 million (2021: € nil) and €184.8 million (2021: €291.9 million) respectively.

In 2021, the ESM was charged an interest rate (Deposit Facility Rate – DFR) of minus 0.50% on the cash held at Eurosystem central banks. Due to the entry into force of the European Central Bank's revised guideline on domestic asset and liability management operations by national central banks on 1 October 2019 and to the discontinuation of EONIA as of 3 January 2022, the remuneration applied to ESM euro cash accounts held at national central banks has changed from the DFR to the lowest rate between zero, the DFR and the €STR. It has been effective as of 3 January 2022 for Banque de France, Deutsche Bundesbank and Banca d'Italia and as of 1 April 2022 for the De Nederlandsche Bank. For harmonisation purposes, the ECB also decided to align its remuneration effective 4 April 2022. On 8 September 2022 the ECB announced a temporary change, effective from 14 September 2022 to 30 April 2023, in the applicable remuneration formula on Eurosystem deposits for public institutions, including the ESM, to the minimum between DFR and €STR. Since then, the ESM cash accounts have been remunerated at positive interest rate at €STR, published daily by the ECB. To limit the negative implications of negative interest rate on the ESM's paid-in capital, the Netherlands have compensated the ESM for the amount charged by their national central bank on the part of ESM paid-in capital that is held in cash deposits. The compensation has been recorded as an extraordinary income (refer to Note 24).

20. Other operating income

The EFSF has asked the ESM to provide administrative and other support services to assist it in performing its activities. To formalise this cooperation, the ESM and EFSF entered into a service level agreement (SLA) from 1 January 2013. On 17 July 2020, the fees calculation section of the Annex to the SLA between the EFSF and the ESM has been amended to reflect the level of activity for cost allocations between the two institutions. Under the amended agreement's terms, the ESM is entitled to charge the EFSF service fees to achieve a fair cost-sharing arrangement. For the services during the financial year 2022, the ESM charged the EFSF €33.1 million (2021: €33.1million), from which €8.3 million had yet to be paid on the balance sheet date (refer to Note 10).

In 2022, the internal tax on salaries retained from staff members amounts to €2.2 million (2021: €2.0 million). Salaries are recorded on a gross basis within staff costs. In accordance with Article 36(5) of the ESM Treaty, such internal tax is for the benefit of the ESM.

21. Net (loss)/profit on financial operations

Net result on financial operations is detailed as follows:

(in €'000)	2021	2020
Net realised result of sales of debt securities	(1,305,471)	154,954
Net foreign exchange result	(601)	(2,323)
One-off adjustment for the change of accounting policy [1]	-	(3,615)
Total net result on financial operations	**(1,306,072)**	**149,016**

[1] The calculation method for results on debt securities including fixed income securities was changed in 2021 from FIFO to AVCO.

The net realised result of sales of debt securities reflects gains and losses realised at the date of derecognition of the respective financial assets. Up to that date, the debt securities as part of the Short-term tranche and the Medium/Long-term tranche of the paid-in capital portfolio are carried at fair value and unrealised gains and losses are recorded in the equity within the fair value reserve.

22. Staff costs

Staff costs are detailed as follows:

(in €'000)	2022	2021
Salaries[1] and allowances	31,165	28,900
Social security costs	1,592	1,479
Pension costs	9,756	8,598
Total staff costs	**42,513**	**38,977**

[1] Of which €2.06 million (31 December 2021: €2.05 million) relate to the ESM Management Board members, including €0.37 million (2021: €0.39 million) to the ESM Managing Director.

The ESM employed 228 persons as at 31 December 2022 (221 as at 31 December 2021).

In addition to its own employees, the ESM has expenses for employees seconded from other international financial institutions, as well as interim, trainees and temporary staff hired from external agencies. The related costs amount to €1.1 million for the 2022 financial year (2021: €2.0 million) and are accounted for as 'Other administrative expenses' (refer to Note 23).

The pension costs represent the ESM's contributions during the financial year to the outsourced employee retirement plan.

Social security costs include the ESM's contributions during the financial year to the health care scheme and for death and disability coverage, which is outsourced to external insurance companies.

23. Other administrative expenses

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

(in €'000)	2022	2021
Outsourced services (mainly IT, HR and accounting services)	14,194	13,451
Advisory services	10,857	10,492
Rental and office building related services	5,903	5,232
Other services	4,754	3,502
IT hardware	3,341	3,023
Treasury related services	3,072	3,054
Interim and secondment fees (Note 22)	1,116	2,047
Legal services	1,023	969
Rating agencies fees	537	576
Total other administrative expenses	**44,797**	**42,346**

24. Extraordinary income

In May 2022, the Netherlands compensated the ESM with €15.2 million for the negative interest charged on the cash held at their national central bank during 2021. No compensation was received from Germany, France, or Italy for negative interest charges on the cash held at their respective central banks during 2021.

In 2021, the extraordinary income was €216.2 million. It was composed of the amounts received from Germany, France, Italy, and the Netherlands being €84.1 million, €62.4 million, €54.5 million, and €15.2 million respectively. The amounts represented a compensation to the ESM for a part of the negative interest charged on the cash held at their national central banks during 2020.

25. Derivatives

The ESM uses derivatives for risk management purposes only, as described in Note 2.6. Since 2015, the ESM has been entering into foreign exchange derivative transactions such as foreign exchange swaps and foreign exchange forward contracts to hedge the currency risk related to short-term non-euro denominated investments. Starting from 2017, the ESM has entered into interest rate swaps and cross-currency swaps for the purpose of hedging interest rate risk on euro and non-euro denominated issued debt, as well as euro and non-euro denominated investments. Since 2019, the ESM has also used bond futures, and since 2020 short-term interest rate futures to manage the interest rate risk of the paid-in capital portfolio.

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

On 31 December 2022, the derivative financial instruments had a maximum maturity up to 30 years (31 December 2021: maximum maturity up to 30 years) and were concluded with euro area central banks, international financial institutions or commercial banks.

The following table discloses the details of the result on derivative contracts during the year ending on 31 December 2022.

(in €'000)	Interest receivable and similar income	Interest payable and similar charges	Net result
Interest result on interest rate swaps[1]	445,613	(783,208)	(337,595)
Interest result on cross-currency swaps	136,999	(91,816)	45,183
Amortised up-front payments on cross-currency swaps	56,941	(21,328)	35,613
Unwind result on cross-currency swaps	373,437	(436,894)	(63,457)
Unwind result on interest rate swaps	818,555	(5,513)	813,042
Spread on foreign exchange swaps	257	(3,143)	(2,886)
Spread on currency forwards	-	(21)	(21)
Result on futures	203,608	-	203,608
Total	**2,035,410**	**(1,341,923)**	**693,487**

[1] The net result from the interest rate swap executed to reduce Greece's interest rate risk is passed through to Greece. (refer to Note 3.6.1.1).

The following table discloses the details of the result on derivative contracts during the year ending on 31 December 2021.

(in €'000)	Interest receivable and similar income	Interest payable and similar charges	Net result
Interest result on interest rate swaps[1]	290,863	(692,940)	(402,077)
Interest result on cross-currency swaps	128,535	(143,078)	(14,543)
Amortised up-front payments on cross-currency swaps	37,617	(6,094)	31,523
Unwind result on cross-currency swaps	8,115	(4,794)	3,321
Unwind result on interest rate swaps	7,166	(4,010)	3,156
Result on futures	14,434	-	14,434
Net result IRBR compensation fee[2]	70,384	(71,286)	(902)
Total	**557,114**	**(922,202)**	**(365,088)**

[1] The net result from the interest rate swap executed to reduce Greece's interest rate risk is passed through to Greece. (refer to Note 3.6.1.1).
[2] One-off compensation fee received or paid by the ESM for the change from EONIA to €STR of the euro short-term benchmark interest rate, applied to cash collateral concluded under the contractual framework of ISDA swap agreements (refer to Note 2.6.4). The net loss of €902 thousand is mainly due to investment-related activities.

The realised part included in 'Interest receivable and similar income' amounts to €2.0 billion (31 December 2021: €557.1 million), while for 'Interest payable and similar charges' this represents €1.3 billion (31 December 2021: €922.2 million).

26. Related-party transactions

KEY MANAGEMENT

The ESM has identified members of the Board of Governors, Board of Directors and the Management Board as key management personnel.

The members of the Board of Governors and the Board of Directors were not entitled to remuneration during the reporting period.

TRANSACTIONS WITH SHAREHOLDERS

The ESM granted loans to Spain, Cyprus and Greece, which are also ESM shareholders, as disclosed in more detail in Note 6. In the course of its investment activity, the ESM purchases debt securities issued by its shareholders. Such securities are reported as 'Debt securities including fixed-income securities' on the balance sheet. On 31 December 2022, the total carrying amount of purchased securities issued by shareholders of the ESM was €8.1 billion (31 December 2021: €2.9 billion).

In 2017, member states expressed their willingness to compensate the ESM up to the amount of negative interest charged by their national central banks with the intention to limit the negative implications on ESM's paid-in capital. The transfers were made under certain conditions and following parliamentary approval. In 2021, the ESM received payments from France, Germany, Italy, and the Netherlands to compensate for the negative interest charged on the cash balances held with their respective national central banks (refer to Note 24).

On 30 September 2021, €84.1 million was received from Germany, on 6 October 2021, €54.5 was received from Italy, on 7 October 2021, €15.2 million was received from the Netherlands and on 18 October 2021, the ESM received €62.4 million from France. These amounts were recorded as an extraordinary income in 2021 (refer to Note 24).

In 2022, the ESM did not receive payments from France, Germany or Italy to compensate for the negative interest charged in 2021 on the cash balances held with their respective national central banks. The ESM received the compensation from the Netherlands; this amount was recorded as an extraordinary income in 2022 (refer to Note 24).

TRANSACTIONS WITH THE EUROPEAN FINANCIAL STABILITY FACILITY (EFSF)

The EFSF is a public limited liability company (*Société Anonyme*) incorporated under Luxembourg law on 7 June 2010 following decisions taken by the euro area member states on 9 May 2010 within the framework of the Ecofin Council. The EFSF's mandate is to safeguard financial stability in Europe by providing financial assistance to euro area member states within the framework of a macro economic adjustment programme.

The EFSF was created as a temporary rescue mechanism. In accordance with its Articles of Association, the EFSF will be dissolved and liquidated when all financial assistance provided to euro area member states and all funding instruments issued by the EFSF have been repaid in full. As of 1 July 2013, the EFSF may no longer engage in new financing programmes or enter into new loan facility agreements.

The EFSF has asked the ESM to provide certain administrative services and other support services to facilitate the performance of its activities. To formalise this cooperation, the two institutions have entered into a service level agreement. In 2020, the SLA Annex was amended to reflect the level of activity for cost allocations between the two institutions. The amendment did not result in a material impact in 2021 compared to previous years. In line with the terms of this agreement, the ESM charged the EFSF €33.1 million for the financial year 2022 (31 December 2021: €33.1 million), from which €8.3 million (31 December 2021: €8.3 million) had not yet been paid at balance sheet date (refer to Note 10). The ESM recognised these amounts as other operating income in the profit and loss account.

27. Audit fee

The total fees accrued in 2022 by the ESM to Ernst & Young, Société Anonyme are presented as follows:

(in €'000)	2022	2021
Audit fees	275	275
Audit related fees	67	92
Total Audit fees	**342**	**367**

In 2022 and 2021, the external auditors provided the ESM with audit-related services in relation to the update of the Information Memorandum relating to the ESM Debt Issuance Programme and the US dollar denominated bond issuance thereunder in 2021.

28. Events after the reporting period

Following the decision of 12 July 2022 of the Council of the European Union on the adoption by Croatia of the euro and its subsequent request to accede to the ESM, the ESM Board of Governors approved the Croatian accession and its detailed technical terms at its meeting on 5 December 2022. On 22 March 2023, Croatia became the 20th Member of the ESM, following the deposit of its instrument of ratification on 2 March 2023. Croatia will benefit from a temporary correction period of 12 years, during which its initial capital subscription to the ESM will be lower, thus leading to a temporarily lower paid-in capital contribution. During the first 12 years of ESM membership, Croatia's authorised capital contribution is €3.7 billion, including €422.29 million in paid-in capital. The payment of paid-in capital will be made in five instalments. Following the end of the correction period, Croatia will contribute an additional €233.0 million. Croatia's accession will increase the total ESM subscribed capital from €704.79 billion to €708.49 billion in 2023 due to the addition of its corrected contribution equal to €3.7 billion.

There have been no other material post-balance sheet events which could require disclosure or adjustment to the 31 December 2022 financial statements.


05

External auditor's report on the 2022 financial statements

To the Board of Governors of the European Stability Mechanism

Report on the audit of the financial statements

Opinion

We have audited the financial statements of European Stability Mechanism (the "Entity" or "ESM"), which comprise the balance sheet as at 31 December 2022, the profit and loss account, the statement of changes in equity and the statement of cash flows for the year then ended, and the notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements give a true and fair view of the financial position of the Entity as at 31 December 2022, and of the results of its operations and its cash flows for the year then ended in accordance with the general principles of the Directive 86/635/EEC of the Council of the European Communities of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions, as amended by Directive 2001/65/EC of 27 September 2001, by Directive 2003/51/EC of 18 June 2003 and by Directive 2006/46/EC of 14 June 2006 (the "Directives").

Basis for opinion

We conducted our audit in accordance with EU Regulation N° 537/2014, the Law of 23 July 2016 on the audit profession (the "Law of 23 July 2016") and with International Standards on Auditing ("ISAs") as adopted for Luxembourg by the "Commission de Surveillance du Secteur Financier" ("CSSF"). Our responsibilities under those Regulation, laws and standards as adopted for Luxembourg by the CSSF are further described in the « Responsibilities of the "réviseur d'entreprises agréé" for the audit of the financial statements » section of our report. We are also independent of the Entity in accordance with the International Code of Ethics for Professional Accountants, including International Independence Standards issued by the International Ethics Standards Board for Accountants ("IESBA Code") as adopted for Luxembourg by the CSSF together with the ethical requirements that are relevant to our audit of the financial statements, and have fulfilled our other ethical responsibilities under those ethical requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key audit matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of the audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Impairment of loans and advances

As at 31 December 2022, loans and advances to euro area Member States amount to EUR 86.2 billion and relate to financial assistance granted to Spain, Cyprus and Greece in line with ESM's mission to provide financial assistance to euro area countries experiencing or threatened by severe financing problems. These loans were granted to recapitalise banks in Spain, and as part of a macroeconomic adjustment programme in the case of Cyprus and Greece. As at 31 December 2022, no impairment has been recorded by ESM on these outstanding loans.

We considered this as a key audit matter as ESM applies complex judgments with respect to the estimation of the amount and timing of the future cash flows when determining the necessity to record or not an impairment loss on the loans granted.

To assess the required impairment allowance and in accordance with article 13(6) of the ESM Treaty - the ESM 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 - ESM assesses individually each loan and advance granted to the beneficiary ESM Members on a regular basis through the analysis of the main following indicators of the beneficiary country:

- the liquidity situation of the sovereign;
- the market access;
- the long-term sustainability of public debt;
- the banking prospects, whenever relevant to assess repayment flows;
- the review of the medium-term economic and financial outlook;
- the identification of default events.

The determination of the necessity to record an impairment will be based on the identification of impairment events and judgments to estimate the impairment against specific loans and advances.

Refer to notes 2 and 6 to the financial statements.

How the matter was addressed in our audit

We assessed the design and implementation and tested the operating effectiveness of the key controls over ESM's processes for establishing and monitoring specific impairment estimation. This included:

- the testing of the entity level controls over the process, including the review and approval of the assumptions made by the Management and the Board of Directors;
- the testing of the quarterly Early Warning System reports issued per country and checking if impairment recommendations have been adequately applied;
- the testing of assumptions underlying judgments made by the Management and the Board of Directors when an impairment event occurs on expected cash flows and estimated recovery from any underlying collateral;
- the testing of a sample of loans to form our own assessment as to whether impairment events have occurred and to assess whether impairment was identified and recorded in a timely manner, where required;
- the reading and assessment of the related contents of the major internal committees' minutes;
- checking that reimbursements and waivers granted are made in accordance with the terms and conditions agreed.
- reconciling amounts disbursed with the loan agreements and ensuring that loans granted to ESM Members are within the limit of commitments approved by the governing bodies of ESM.

Responsibilities of the Board of Directors and of those charged with governance for the financial statements

The Board of Directors is responsible for the preparation and fair presentation of the financial statements in accordance with the general principles of the Directive 86/635/EEC of the Council of the European Communities of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions, as amended by Directive 2001/65/EC of 27 September 2001, by Directive 2003/51/EC of 18 June 2003 and by Directive 2006/46/EC of 14 June

2006 (the "Directives"), and for such internal control as the Board of Directors determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, the Board of Directors is responsible for assessing the entity's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the Board of Directors either intends to liquidate the Entity or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Entity's financial reporting process.

Responsibilities of the "réviseur d'entreprises agréé" for the audit of the financial statements

The objectives of our audit are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue a report of the "réviseur d'entreprises agréé" that includes our opinion. Reasonable assurance is a high level of assurance but is not a guarantee that an audit conducted in accordance with EU Regulation N° 537/2014, the Law of 23 July 2016 and with the ISAs as adopted for Luxembourg by the CSSF will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with EU Regulation N° 537/2014, the Law of 23 July 2016 and with ISAs as adopted for Luxembourg by the CSSF, we exercise professional judgment and maintain professional skepticism throughout the audit.

We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Entity's internal control.

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the Board of Directors.

- Conclude on the appropriateness of Board of Directors' use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Entity's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our report of the "réviseur d'entreprises agréé" to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our report of the "réviseur d'entreprises agréé". However, future events or conditions may cause the Entity to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, actions taken to eliminate threats or safeguards applied.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our report unless law or regulation precludes public disclosure about the matter.

Report on other legal and regulatory requirements

In 2017, the Board of Governors had appointed Ernst & Young as the ESM's external auditor for a three-year term, renewable once. We have been re-appointed as "réviseur d'entreprises agréé" by the Board of Governors on 11 June 2020 for a three-year term and the duration of our uninterrupted engagement, including previous renewals and reappointments, is 6 years.

We confirm that the audit opinion is consistent with the additional report to the audit committee or equivalent.

We confirm that the prohibited non-audit services referred to in EU Regulation No 537/2014 were not provided and that we remained independent of the Entity in conducting the audit.

Ernst & Young
Société anonyme
Cabinet de révision agréé

Bernard Lhoest
Luxembourg, 30 March 2023


06

Report of the Board of Auditors on the 2022 financial statements

Luxembourg, 30 March 2023

The Board of Auditors of the European Stability Mechanism (ESM) was set up pursuant to Article 30 of the Treaty establishing the ESM and Article 24 of the ESM By-Laws. The Board of Auditors is independent from the Board of Directors and its members are appointed directly by the Board of Governors.[12]

This Board of Auditors report in respect of the financial statements is addressed to the Board of Governors in accordance with Article 23 (2) (d) of the ESM By-Laws. It is delivered in respect of the financial statements of the ESM for the year ended 31 December 2022.

The Board of Auditors notes that based on its own work and considering the work of the external auditor, to the best of its judgment, no material matters have come to its attention that would prevent it from recommending that the Board of Governors approve the financial statements of the ESM for the year ended 31 December 2022.

On behalf of the Board of Auditors

Helga Berger
Chairperson

[12] The Board of Auditors carries out independent audits of regularity, compliance, performance, and risk management of the ESM, inspects the ESM accounts, and monitors and reviews the ESM's internal and external audit processes and their results. Information on the audit work of the Board of Auditors, its audit findings, conclusions, and recommendations for the year ended 31 December 2022 will be included in the annual report, to be prepared in accordance with Article 24(6) of the ESM By-Laws and submitted to the Board of Governors.

Acronyms and abbreviations

ECB	European Central Bank
EFSF	European Financial Stability Facility
ESG	Environmental, social, and governance
ESM	European Stability Mechanism
EU	European Union
GDP	Gross domestic product
GNI*	Modified gross national income
IT	Information technology
NPL	Non-performing loan
UN	United Nations
US	United States
€STR	Euro short-term rate

EURO AREA

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

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