The European Stability Mechanism in the context of the sovereign debt crisis

Dr. Ulrich Forsthoft, Senior Legal Officer, ESM

Conférence Saint-Yves

Luxembourg, 21 January 2016
I. The origins of the crisis

II. Overview on EFSF/ESM

III. EFSF/ESM Programmes

IV. ESM Strategy

V. How the ESM operates
I. The origins of the crisis
Important reasons for the sovereign debt crisis

1. Member States did not fully accept the political constraints of being in EMU
2. Transition to permanent lower interest rates
3. Economic surveillance too narrow
4. Insufficient control of data by Eurostat
5. Capital markets did not price different risk accordingly
6. Biggest financial crisis in 80 years
Timeline: from financial to sovereign debt crisis

From mid-2007
• Subprime crisis – banks and hedge funds that invested in subprime mortgages are left with worthless assets

Sept. 2008
• Lehman Brothers files for bankruptcy
  • Irish banks, already over-exposed to local property bubble, come under pressure due to global financial crisis; Irish govt. issues unlimited guarantee covering all bank loans

Oct. 2008
• US Congress approves $700 bn purchase of distressed assets from banks

Oct. 2009
• Greek government announces that its fiscal deficit amounts to 12.7% of GDP, much worse than claimed before
II. Overview on EFSF/ESM
### Overview

<table>
<thead>
<tr>
<th>Legal Structure</th>
<th>Private company under Luxembourg law</th>
<th>Inter-governmental institution under international law</th>
</tr>
</thead>
<tbody>
<tr>
<td>Duration</td>
<td>Temporary (June 2010-June 2013)*</td>
<td>Permanent institution</td>
</tr>
<tr>
<td>Capital structure</td>
<td>Backed by guarantees of Euro Area Member States</td>
<td>Subscribed capital of €704.8bn** €80.5bn in paid-in capital €624.3 bn in committed callable capital</td>
</tr>
<tr>
<td>Maximum Lending capacity</td>
<td>€192bn committed for Ireland, Portugal &amp; Greece*</td>
<td>€500bn</td>
</tr>
<tr>
<td>Creditor status</td>
<td>Pari passu</td>
<td>Preferred creditor status (after IMF) ***</td>
</tr>
<tr>
<td>Credit Rating</td>
<td>AA / Aa1 / AA+</td>
<td>- / Aa1 / AAA</td>
</tr>
<tr>
<td>Risk Weighting</td>
<td>0%****</td>
<td>0%****</td>
</tr>
</tbody>
</table>

* Since 01/07/2013, EFSF can no longer engage in new financing programmes.
** The initial subscribed capital of €700 bn has increased since the accession of Latvia in March 2014 and of Lithuania in February 2015.
*** For the financial assistance for recapitalisation of the Spanish banking sector, pari passu will apply.
**** Regulation (EU) no. 575/2013 (Capital Requirements Regulation), Article 118. Following a decision published by the Basel Committee on Banking Supervision on 18 March 2014, EFSF & ESM securities will be included in the list of entities receiving a 0% risk weighting under Basel II.
## Financial Backstops – EFSF and ESM Timeline

<table>
<thead>
<tr>
<th>Date</th>
<th>Event Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>11 April</td>
<td>Eurogroup agreement on the first support package for <strong>Greece</strong> <em>(Greek loan facility)</em></td>
</tr>
<tr>
<td>13 May</td>
<td><strong>European Financial Stability Mechanism (EFSM)</strong> was established (Article 122 para. 2 TFEU)</td>
</tr>
<tr>
<td>7 June</td>
<td><strong>European Financial Stability Facility (EFSF)</strong> was created</td>
</tr>
<tr>
<td>28 November</td>
<td>Agreement of financial assistance programme for <strong>Ireland</strong> <em>(€85bn)</em></td>
</tr>
<tr>
<td>17 May</td>
<td>Agreement of financial assistance programme for <strong>Portugal</strong> <em>(€78bn)</em></td>
</tr>
<tr>
<td>20 June</td>
<td>Agreement by euro area and EU finance ministers to increase EFSF effective lending capacity, widen scope of mandate and finalise terms of permanent stability mechanism, <strong>European Stability Mechanism</strong></td>
</tr>
<tr>
<td>21 July</td>
<td>Euro area summit, second support package for <strong>Greece</strong> and increased scope for EFSF/ESM</td>
</tr>
<tr>
<td>2 February</td>
<td><strong>ESM Treaty</strong> signed</td>
</tr>
<tr>
<td>14 March</td>
<td>Second <strong>Greek</strong> programme formally approved by Eurogroup Working Group</td>
</tr>
<tr>
<td>20 July</td>
<td>Eurogroup approves financial assistance to <strong>Spain’s</strong> banking sector</td>
</tr>
<tr>
<td>12 September</td>
<td>German Constitutional Court rejects a request for a temporary injunction: <strong>Germany</strong> may ratify the ESM Treaty</td>
</tr>
<tr>
<td>27 September</td>
<td>ESM Treaty enters into force; interpretative declaration</td>
</tr>
<tr>
<td>8 October</td>
<td><strong>ESM inaugurated</strong></td>
</tr>
<tr>
<td>27 November</td>
<td><strong>Pringle</strong> judgment of the <strong>European Court of Justice</strong></td>
</tr>
<tr>
<td>29 November</td>
<td>Financial Assistance Facility Agreement with <strong>Spain</strong> <em>(€100bn)</em></td>
</tr>
</tbody>
</table>
# Financial Backstops – EFSF and ESM Timeline

<table>
<thead>
<tr>
<th>Date</th>
<th>Event Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>2013</strong></td>
<td></td>
</tr>
<tr>
<td>8 January</td>
<td>ESM launches its short term programme with its 1st bill auction</td>
</tr>
<tr>
<td>8 May</td>
<td>Financial Assistance Facility Agreement with <strong>Cyprus</strong> (€9bn)</td>
</tr>
<tr>
<td>1 July</td>
<td>EFSF may no longer finance new programmes nor enter into new facility agreements*</td>
</tr>
<tr>
<td>8 October</td>
<td>ESM launched its long-term funding programme with a €7 billion 5-year benchmark bond</td>
</tr>
<tr>
<td>8 December</td>
<td><strong>Ireland</strong> successfully exits EFSF financial assistance programme</td>
</tr>
<tr>
<td>31 December</td>
<td><strong>Spain</strong> successfully exits ESM financial assistance programme</td>
</tr>
<tr>
<td><strong>2014</strong></td>
<td></td>
</tr>
<tr>
<td>13 March</td>
<td><strong>Latvia</strong> joins the ESM</td>
</tr>
<tr>
<td>30 April</td>
<td>ESM reaches target level of €80bn in paid-in capital</td>
</tr>
<tr>
<td>18 May</td>
<td><strong>Portugal</strong> successfully exits EFSF financial assistance programme</td>
</tr>
<tr>
<td><strong>2015</strong></td>
<td></td>
</tr>
<tr>
<td>3 February</td>
<td><strong>Lithuania</strong> joins the ESM</td>
</tr>
<tr>
<td>30 June</td>
<td>Second <strong>Greek</strong> programme (EFSF) expires</td>
</tr>
<tr>
<td>19 August</td>
<td>ESM Financial Assistance Facility Agreement with <strong>Greece</strong> (up to €86bn)</td>
</tr>
</tbody>
</table>

* However, EFSF will remain active in the long-term bond market in order to finance the ongoing programmes for Ireland, Portugal and Greece, and roll over existing debt.
III. EFSF/ESM programmes
What have we done so far?

- Five countries have received assistance
  - Comprehensive reform packages for Portugal, Greece, Ireland and Cyprus
  - Programme to restructure the financial sector in Spain
  - Amount paid to five countries so far: €254bn
  - Support for the banking sector has been important:
    » €41.3bn in indirect bank recapitalisation to Spain
    » €37.3bn (EFSF programme) and €5.4bn (ESM programme) to Greece
    » €1.5bn to Cyprus
  - Ireland, Spain and Portugal have exited their programmes
  - Cyprus will exit its programme in March 2016
EFSF and ESM Programmes

- The **EFSF** has provided financial assistance to Ireland, Portugal and Greece

<table>
<thead>
<tr>
<th>Country</th>
<th>Total programme amount (€ bn)</th>
<th>Amount financed by EFSF (€ bn)</th>
<th>Disbursed amount (€ bn)</th>
<th>Remaining amount (€ bn)</th>
<th>Outstanding amount (€ bn)</th>
<th>Average maturity (years)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ireland</td>
<td>85.0</td>
<td>17.7</td>
<td>17.7</td>
<td>0.0</td>
<td>17.7</td>
<td>20.7</td>
</tr>
<tr>
<td>Portugal</td>
<td>78.0</td>
<td>26.0</td>
<td>26.0</td>
<td>0.0</td>
<td>26.0</td>
<td>20.8</td>
</tr>
<tr>
<td>Greece</td>
<td>164.4</td>
<td>141.8</td>
<td>141.8</td>
<td>0.0</td>
<td>130.9</td>
<td>31.1*</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>327.4</strong></td>
<td><strong>185.5</strong></td>
<td><strong>185.5</strong></td>
<td><strong>0.0</strong></td>
<td><strong>174.6</strong></td>
<td></td>
</tr>
</tbody>
</table>

- The **ESM** has provided financial assistance to Spain, Cyprus and Greece

<table>
<thead>
<tr>
<th>Country</th>
<th>Total programme amount (€ bn)</th>
<th>Amount financed by ESM (€ bn)</th>
<th>Disbursed amount (€ bn)</th>
<th>Remaining amount (€ bn)</th>
<th>Outstanding amount (€ bn)</th>
<th>Average maturity (years)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spain</td>
<td>41.3</td>
<td>41.3</td>
<td>41.3</td>
<td>0.0</td>
<td>35.7</td>
<td>12.5</td>
</tr>
<tr>
<td>Cyprus</td>
<td>10.0</td>
<td>9.0</td>
<td>5.8</td>
<td>3.2</td>
<td>5.8</td>
<td>14.9</td>
</tr>
<tr>
<td>Greece</td>
<td>86.0</td>
<td>tbd</td>
<td>21.4</td>
<td>64.6</td>
<td>21.4</td>
<td>32.5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>137.3</strong></td>
<td><strong>50.3</strong></td>
<td><strong>68.5</strong></td>
<td><strong>67.8</strong></td>
<td><strong>62.9</strong></td>
<td></td>
</tr>
</tbody>
</table>

* Assuming final maturity following the rollover of disbursed portions to final maturity

**Total amount disbursed by EFSF and ESM:**

€254 billion

**Total amount outstanding EFSF and ESM loans:**

€237.5 billion
The three Greek programmes

The new ESM programme is the third programme for Greece

1st programme* (2010-2011)
- Greek Loan Facility: €52.9bn
- IMF: €20.1bn
- **total: €73bn**

2nd programme* (2012-2015)
- EFSF: €141.8bn
- IMF: €11.7bn
- **total: €153.5bn**

3rd programme (2015-2018)
- ESM: up to €86bn (committed); €26bn approved out of which €21.4bn are disbursed
- IMF: to be discussed

* Note: For the first two programmes, amounts disbursed are shown.
Greece was successfully growing out of the crisis in 2014

Structural reforms

- Greece topped the OECD ranking on structural reforms, gained 48 positions in the overall ranking in the World Bank’s *Ease of Doing Business* index
- Greece was well positioned for future growth if it continued the reforms
  - Unit labour costs improvement (-1.8%)
  - Fiscal surplus of 0.8%
  - Exports rising 1.8% and imports declining 5.3%

Macroeconomics

- GDP expanded by 1% in 2014, and forecasted to reach 2.9% in 2015 and 3.7% in 2016
- Unemployment decreased from the peak (27.5%) in 2013, to 26.8% in 2014

Capital Markets

- Greece successfully issued a 5-year bond in April 2014 (rate of 4.95%) and 3-year bond in July 2015 (3.5%)

Greece’s intention was to wrap up the program and potentially go for a precautionary credit line.

- Market reaction was mixed to this intention (bond yields increased)
- There was no agreement for closure of EFSF programme review

Therefore, Greece requested a technical extension of the programme in December 2014
Change of track had large consequences in 2015

- Two elections and one referendum
- Reforms were frozen or turned back
  - Macroeconomic impact:
    - GDP forecast level reduced from 2.9% to 0.5% in 2015
    - Unemployment forecast increased (0.6% in 2015, 1.2% in 2016)
- April: private sector deposits in Greek banks fell by €30.6bn (19%). Lowest level in more than a decade.
- June: Greece closed banks and imposed capital controls
- End June: 2\textsuperscript{nd} EFSF bailout program ends. Greece misses €1.6bn payment to IMF. EFSF declared default.
  - Capital Markets: Bonds yield increase to a peak of 19.4% (10y) and 35.86% (5y)
IV. ESM Strategy
How does the ESM Strategy work?

- The ESM grants loans with low interest rates subject to strict conditionality.

- MS have to implement reforms.
  - Budgetary consolidation
  - Structural reforms
  - Modernisation of the administration

- Increasing competitiveness of the MS.
  - Unit labour costs decline.
  - Current account balances improves.

- Investors trust again in the MS. MS regain access to the capital markets and are able to refinance themselves.
  - GDP grows.
  - Unemployment decreases.
Deficit reduction policies are paying off

Source: European Commission, Economic Forecast – Spring 2015

* Actual figure for Ireland in 2010: -32.4%
Internal devaluations are restoring competitiveness

Nominal unit labour costs (2000=100)

Current account balance (% of GDP)

Source: EC European Economic Forecast – Spring 2015
GDP growth is picking up in all programme countries

Source: EC European Economic Forecast – Autumn 2015
Greece, Ireland, Portugal and Spain are in top 5 of 34 OECD countries with regard to implementation of structural reforms.

Ranking in OECD report

1. Greece
2. Ireland
3. Estonia
4. Portugal
5. Spain

“Euro area countries under financial assistance programmes are among the OECD countries whose responsiveness [to the OECD’s structural reform recommendations] was highest and also where it most increased compared with previous period.”

- Going for Growth (OECD Report)

Source: OECD report Going for Growth for 2015
Ranking takes into account responsiveness to OECD recommendations on structural reforms in key policy areas.
## Benefits of EFSF/ESM Lending: Loans are euro area solidarity

### Savings via EFSF/ESM financing vs theoretical market cost (for 2014)

<table>
<thead>
<tr>
<th>Country</th>
<th>In € billion</th>
<th>As percentage of GDP</th>
<th>As percentage of total primary expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cyprus</td>
<td>0.26</td>
<td>1.5</td>
<td>4.3</td>
</tr>
<tr>
<td>Greece</td>
<td>7.87</td>
<td>4.4</td>
<td>10.86</td>
</tr>
<tr>
<td>Ireland</td>
<td>0.09</td>
<td>0.05</td>
<td>0.15</td>
</tr>
<tr>
<td>Spain</td>
<td>0.82</td>
<td>0.08</td>
<td>0.21</td>
</tr>
<tr>
<td>Portugal</td>
<td>0.49</td>
<td>0.28</td>
<td>0.69</td>
</tr>
</tbody>
</table>

*Calculated using the average sovereign market spread of each country matching the EFSF/ESM maturity profile. This is compared with the equivalent EFSF/ESM funding cost.*
Benefits of EFSF/ESM lending

1. All Member States have remained in the euro area.

2. EFSF/ESM programmes promote fiscal adjustment and structural reforms.

3. EFSF/ESM lending supports return to debt sustainability.
V. How the ESM operates
Purpose of the ESM

**Article 3 of the ESM Treaty**

The purpose of the ESM shall be to **mobilise funding** and **provide stability support** under **strict conditionality**, **appropriate to the financial assistance instrument chosen**, to the benefit of ESM Members which are experiencing, or are threatened by, severe financing problems, if indispensable **to safeguard the financial stability of the euro area as a whole and of its Member States**. For this purpose, the ESM shall be entitled to **raise funds** by issuing financial instruments or by entering into financial or other agreements or arrangements with ESM Members, financial institutions or other third parties.

- Provide stability support under strict conditionality
- Mobilise funding
- Prudent investment of paid-in capital
ESM: mission and scope of activity
Financial instruments

■ Loans
  - Objective: assist MS that have significant financing needs but have lost access to market financing.
  - MoU (negotiated by EC, in liaison with ECB and where possible IMF) details conditionality.

■ Primary market purchases
  - Objective: allow MS to maintain or restore market access.
  - For use by MS under macro-economic adjustment programme or under precautionary programme.

■ Secondary market purchases
  - Objective: support functioning of debt markets and appropriate price formation in government bonds.
  - For use by programme and non-programme countries, with conditionality. Subject to ECB report identifying risk to euro area and assessing need for intervention.

■ Precautionary programme
  - Objective: prevent crisis situations by assistance before MS face difficulties in raising funds and avoid negative connotation of being a programme country.

■ Bank recapitalisation through loans to governments
  - Limit contagion of financial stress by assisting a country to finance recapitalisation of bank(s) at sustainable borrowing costs.
  - Sector specific conditionality.

■ Direct Bank recapitalisation
  - To break the vicious link between the sovereign and the banking sector, assistance to the MS through taking an equity stake banks.
ESM contractual framework

- **The FFA**
  - The FFA is the only document that needs to be formally signed and negotiated. By signing the FFA (= a ‘10-pager’), the General Terms and the relevant Facility Specific Terms are automatically applicable and incorporated into the agreement.

- Parties to the FFA are always: (i) the ESM, (ii) the beneficiary ESM Member, and (iii) the relevant Central Bank.

- **The FST**
  - The Facility Specific Terms contain all ESM financial instruments and their specific terms, conditions and procedures. They are based on the relevant detailed Guidelines for each financial instrument.

  - The terms and conditions of the FST could overwrite/complement or modify any clause under the GT.

- **The GT**
  - The General Terms set out the terms, conditions and procedures generally applicable to all ESM financial assistance facility agreements, regardless of the financial instrument used.
Conditionality

- Detailed in the MoU, which is negotiated by the Commission (in liaison with the ECB and, wherever possible, together with the IMF).

- Consistency of the MoU with the macroeconomic adjustment programme of the MS concerned approved by the Council under Regulation (EU) No 472/2013 (Article 7 para. 2 Regulation No 472/2013).

- Appropriate to the financial assistance instrument chosen, e.g.
  - Budgetary consolidation
  - Structural reforms
  - Modernisation of the administration
  - In case of indirect bank recapitalisation: financial sector specific or institution specific conditionality
ESM Funding Strategy

- Providing beneficiary countries with funding at best conditions with priority given to:
  - mitigating ESM liquidity and interest rate risk
  - proposing the best balance between costs and maturities

Funding strategy

**Short term funding**
- Regular bill programme
- Unsecured money market

**Long term funding**
- Highly liquid benchmark bonds
  - Up to 30 years
  - Taps possible
  - Via syndications, auctions
  - Private placements
  - Non euro currencies allowed

**Cashless transactions**
- Issue & Repurchase Process

**Fund pool**
- Funds are not attributed to one country but pooled
- One unique rate for all countries

Diversified Funding Strategy
Capital structure

- ESM's subscribed capital exceeds maximum lending capacity by 40%

- Investment policy
  - Ensure highest creditworthiness of the ESM
  - Constant availability of ESM's maximum lending volume: Minimum 15% ratio of paid-in capital/amount of ESM indebtedness
  - Ensure liquidity (e.g. to cover shortfalls or for an emergency procedure)
  - Return

* The initial subscribed capital of €700bn has increased since the accession of Latvia and Lithuania in 2014/2015.
Who we are

- **The ESM is the biggest International Financial Institution in the World in terms of capital and balance sheet.**
- **The ESM is a modern, efficient and cost-effective institution.**
- **The ESM is a very lean institution: 151 staff members.**
  - Recruitment is not restricted to EU citizens (China, Zimbabwe, Kazakhstan, United States etc.)
  - Working language: English
  - Mix of employees with a background in the private sector and in the public sector
- **Many non-core functions are outsourced to the private sector.**
- **The ESM is based in Luxembourg.**
Contact

Dr. Ulrich Forsthoff
Senior Legal Officer
Phone +352 260 962 311
u.forsthoff@esm.europa.eu

Wolfgang Proissl
Chief Spokesperson
Phone +352 260 962 230
w.proissl@esm.europa.eu

Luis Rego
Deputy Spokesperson
Phone +352 260 962 235
l.rego@esm.europa.eu

Follow ESM on Twitter:
@ESM_Press

Follow ESM on Weibo:
www.weibo.com/5293104429

ESM website:
www.esm.europa.eu