Jean Monnet Module

“Economic Policy in the European Union”

Session 3.1. European Stability Mechanism: crisis management and prevention mechanism

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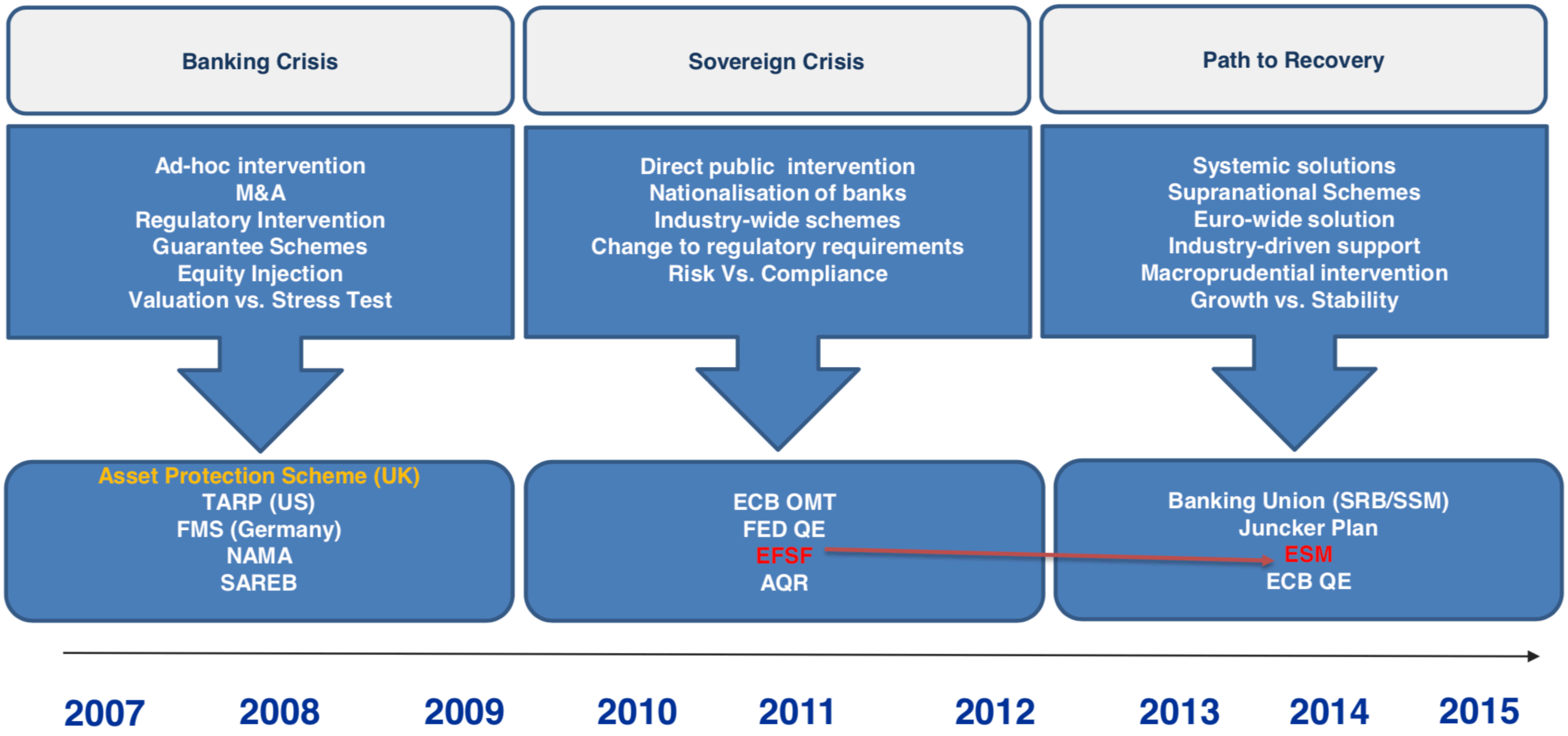
With the support of the Erasmus+ Programme of the European Union

THE 2007/12 CRISIS HAS AFFECTED THE FINANCIAL STABILITY OF ADVANCED ECONOMIES DUE TO:

- Financial sector bubbles
- System fixes hindered by growing connections between financial players
- Contingent liabilities and the accumulation of losses posed a threat to the sovereign creditworthiness of some European countries
- Series of unique events in different key economies
- As a result of the euro debt crisis, it became necessary to provide financial assistance to countries to meet their sovereign debt obligations


Banking Crisis
Sovereign Crisis
Path to Recovery
Ad-hoc intervention
M&A
Regulatory Intervention
Guarantee Schemes
Equity Injection
Valuation vs. Stress Test
Direct public intervention
Nationalisation of banks
Industry-wide schemes
Change to regulatory requirements
Risk Vs. Compliance
Systemic solutions
Supranational Schemes
Euro-wide solution
Industry-driven support
Macroprudential intervention
Growth vs. Stability
Asset Protection Scheme (UK)
TARP (US)
FMS (Germany)
NAMA
SAREB
ECB OMT
FED QE
EFSF
AQR
Banking Union (SRB/SSM)
Juncker Plan
ESM
ECB QE
2007
2008
2009
2010
2011
2012
2013
2014
2015

OVERVIEW OF THE EU RESPONSE TO THE CRISIS

Fuente: Buti (2011).

“The European Economic Commission, the Council, the [European] Parliament, the Court of Justice are a pre-federal model. But they are not the organs of a political federation of Europe that will eventually emerge from a specific creative action that will require a new delegation of sovereignty. It will be necessary to return to the sources of power, first to complete the economic union that has been deprived of its momentum for too long, and then to find the form of a more complete and profound union [...] What we are preparing for through the [European] Community is probably unprecedented. This Community itself relies on institutions that need to be strengthened. But we must also bear in mind that the true political authority that European democracies will one day be granted remains to be designed and implemented”.

Jean Monnet, Memoirs, 1976

WHAT DID WE LEARN?

- Financial institutions had to develop the capacity to reduce the impact of systemic events
- Financial conditions had to be tested and reviewed on an ongoing basis
- It was necessary to establish the correlation between the mitigation of financial crises and sovereign crises
- It was necessary to address the social impact of crises
- Regulation was to provide a sustainable playing field for agents
- The financial system should continue to finance the real economy
- The new challenges required contingency planning of higher proportions than in the past

INTERVENTION MECHANISMS

Mechanisms to cope with financial turmoil in the Eurozone:

- **European Financial Stability Facility** (EFSF)
- **European Financial Stabilization Mechanism** (MEEF)

EUROPEAN FINANCIAL STABILITY FUND (I)

It is a special legal entity of an instrumental and temporary nature, approved by the 28 States of the EU in May 2010, whose main objective is to preserve financial stability in Europe through the offer of **financial assistance to States of the euro area that are are in a situation of economic crisis.**

The EFSF has been assigned the best possible credit rating.

The countries guarantee 120% of their participation in the credit line, which will be used to cover the amounts drawn down for loans.

EUROPEAN FINANCIAL STABILITY FUND (II)

The EFSF is authorized to borrow up to € 440 billion (through the issuance of bonds or other debt instruments).

Through the EFSF, the bailouts of Greece, Ireland and Portugal were facilitated.

It is an example of inter-institutional coordination: the European Commission establishes the conditionality in coordination with the European Central Bank and the International Monetary Fund and must be approved by the Eurogroup.

EUROPEAN FINANCIAL STABILITY MECHANISM

Emergency financing program dependent on funds raised in financial markets and guaranteed by the European Commission through the EU Budget.

It takes the form of a loan or a line of credit.

Objective: to preserve financial stability, providing financial assistance to EU states in a situation of economic crisis.

The EFSM was able to dispose of up to 60 billion euros, which, together with the 440,000 from the EFSF (Stability Fund or Facility), reached € 500,000 million, which was **insufficient in view of the virulence of the crisis for the affected countries**.

Through the MEEF the money was provided to Ireland and Portugal.

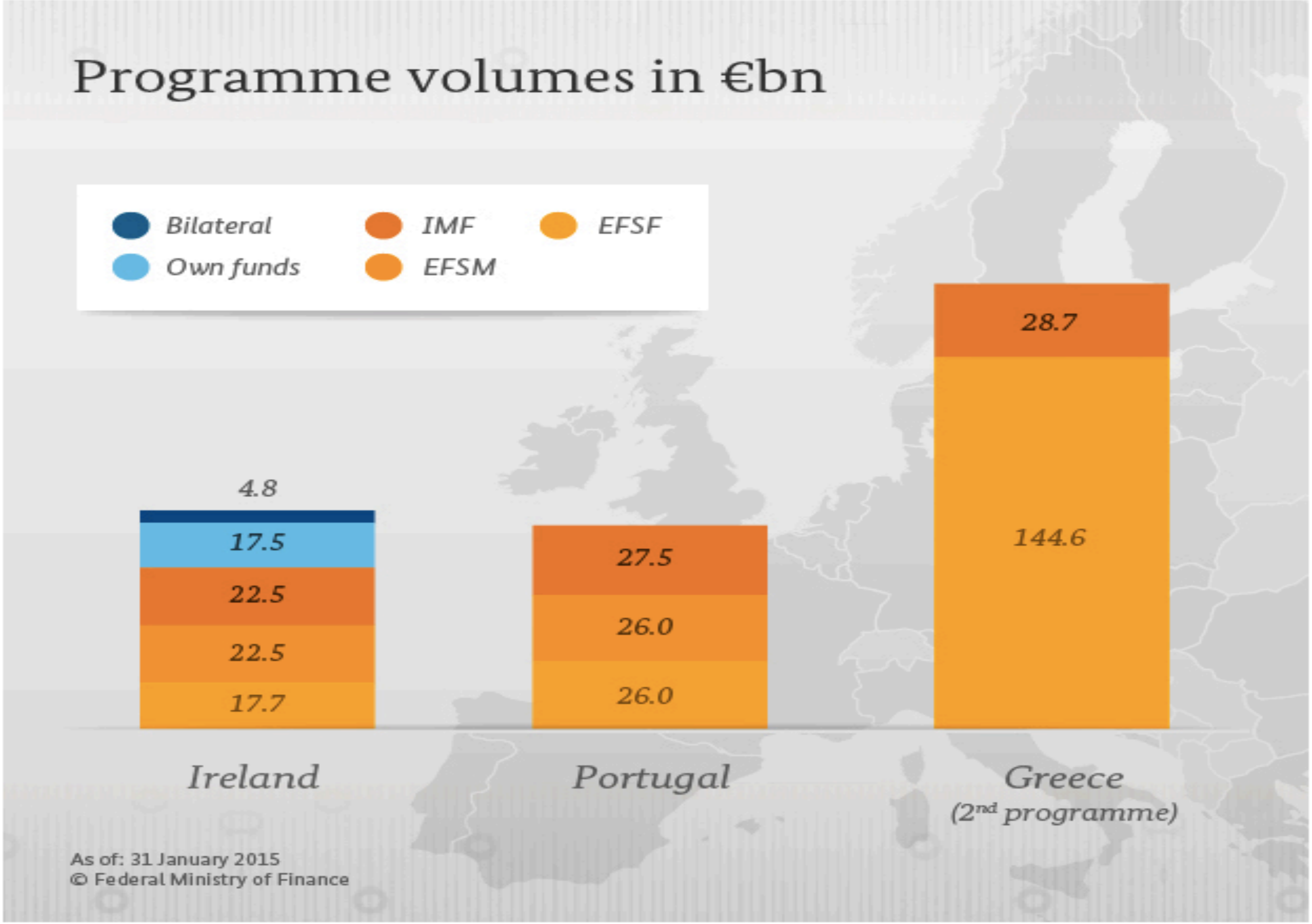
APPLYING PROCESS

The EU country applying for financial assistance will carry out an assessment of its financial needs with the Commission and in collaboration with the ECB.

It will then submit a draft economic and financial recovery program to the Commission.

The decision to grant a line of credit will contain the following information:

- the precise conditions of the financial aid
- the general economic policy conditions accompanying EU financial assistance (e.g., fiscal consolidation measures to reduce public debt)
- approval of the adjustment program prepared by the host country
- The Commission will verify at regular intervals whether the economic policy of the beneficiary country is in line with its adjustment program and with the conditions established by the Council to continue receiving financial assistance, which is granted in instalments


Programme volumes in €bn
Bilateral
Own funds
IMF
EFSM
EFSF
4.8
17.5
22.5
22.5
17.7
27.5
26.0
26.0
28.7
144.6
Ireland
Portugal
Greece
(2nd programme)
As of: 31 January 2015
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EUROPEAN STABILITY MECHANISM

Introduced in March 2011 as a permanent mechanism for crisis management to safeguard financial stability in the eurozone, it became operational in October 2012.

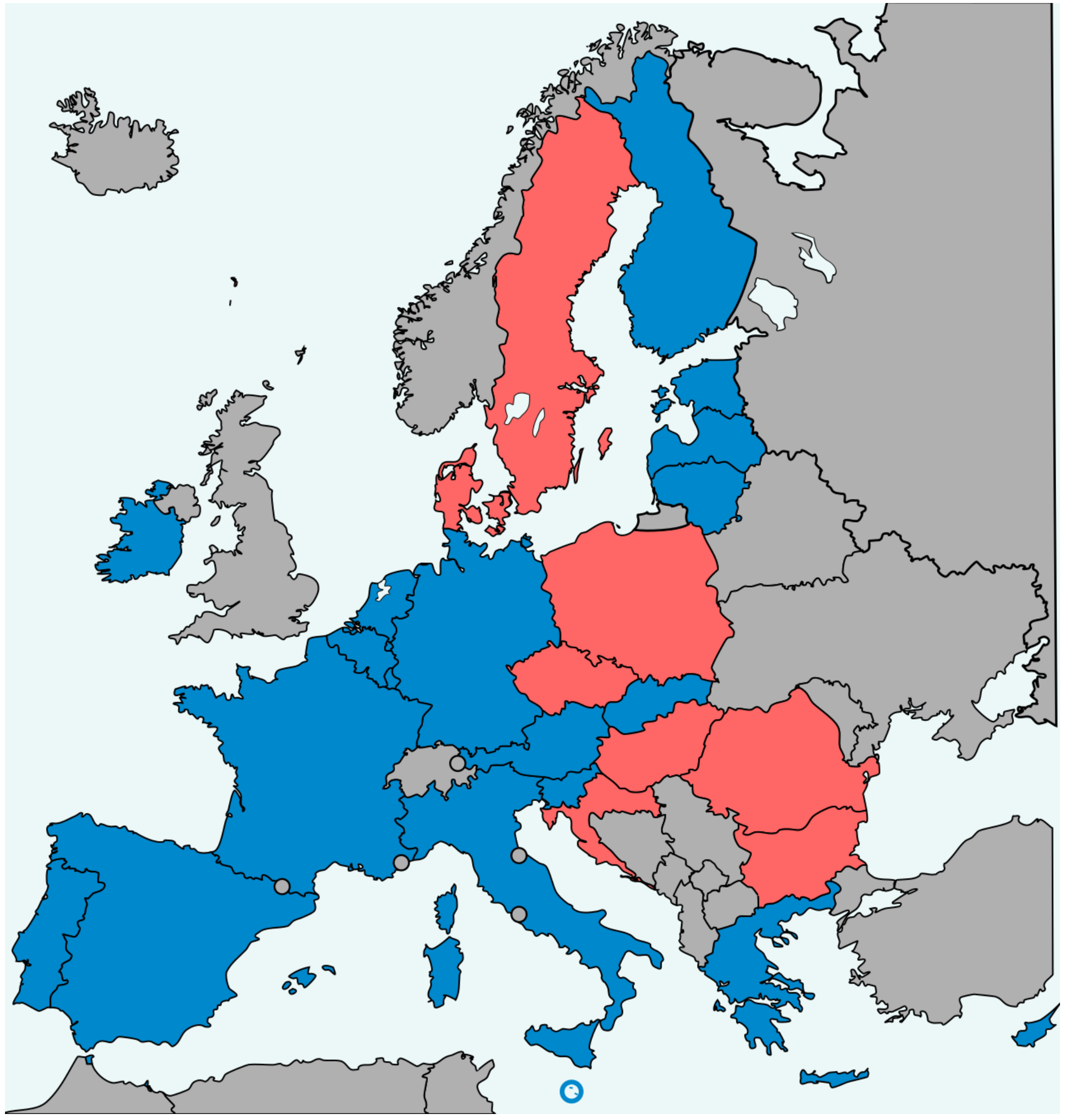
It replaces the European Financial Stability Fund and the European Financial Stability Mechanism.

It has a budget of 705 billion euros = 80 billion euros reimbursed by the EEMM (system of participations in the capital of the ECB) + 625 billion euros of callable capital and guarantees of the members of the Eurozone.

Up to 500 billion - the effective lending capacity of the ESM.

MEMBER STATES (20)

Austria	Belgium	Cyprus	Italy
Estonia	Finland	Portugal	Slovakia
France	Germany	Slovenia	Spain
Greece	Ireland	Malta	Netherlands
Latvia	Luxembourg	Lithuania	Croatia



LEGAL SUSTENANCE

The ESM established by the intergovernmental treaty was designed to be fully compatible with current EU legislation.

The EU Court of Justice ruled in November 2012 that "the right of a Member State to conclude and ratify the ESM Treaty is not subject to the entry into force" of the amendment to the TFEU.

The TFEU amendment entered into force on May 1, 2013, after the Czech Republic became the last member state to ratify the agreement in accordance with their respective constitutional requirements.

INSTITUTIONAL STRUCTURE

Board of Governors:

- made up of the Ministers of Economy and Finance of the euro area countries
- in charge of adopting the most important decisions
- makes decisions unanimously
- is chaired by the President of the Eurogroup
- representatives of the EC and the ECB may participate in their meetings as observers

Board of Directors:

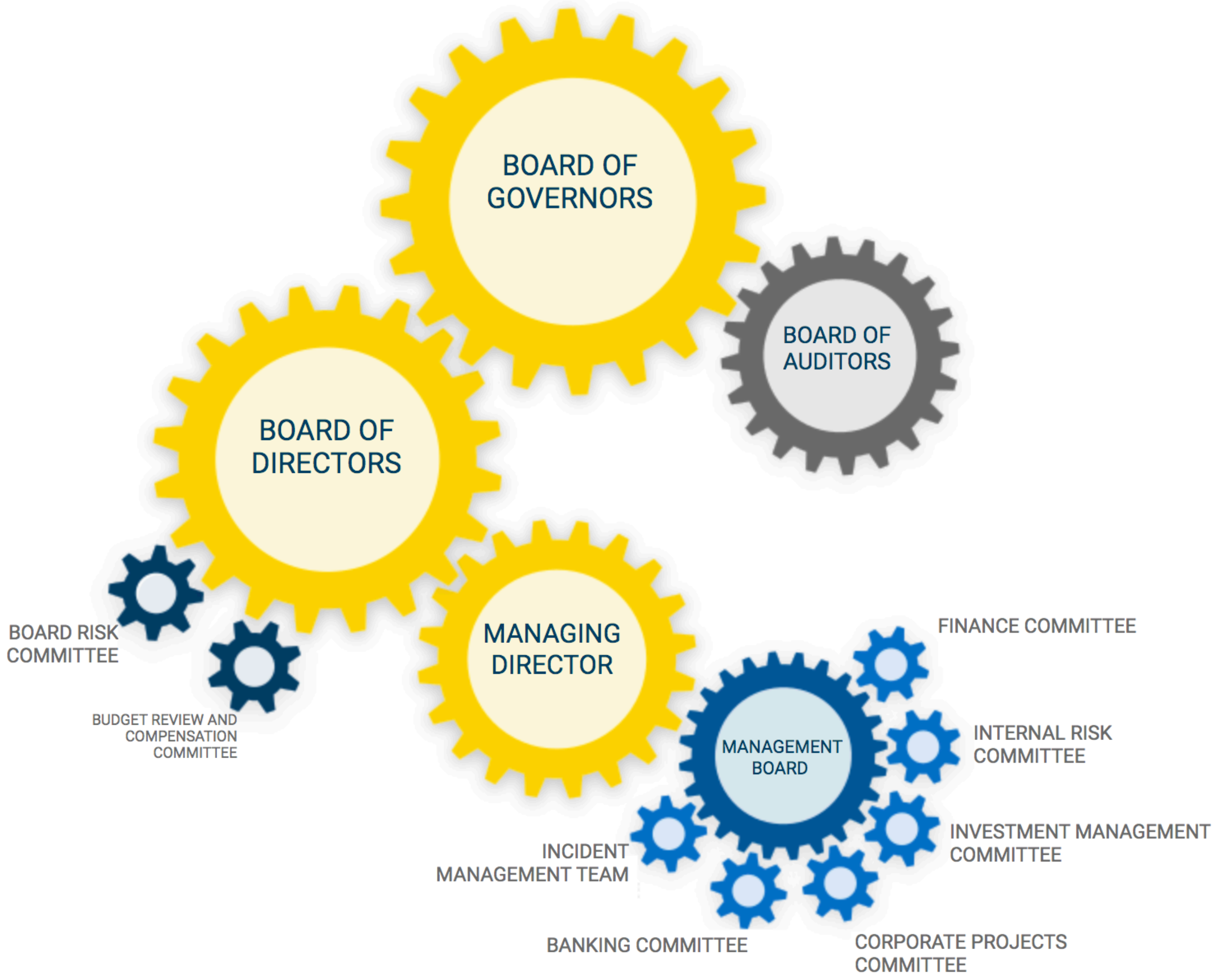
- named by the euro zone countries
- performs those specific tasks delegated to it by the Board of Governors
- it is made up of senior civil servants from each member of the ESM who are highly competent in economic and financial matters
- ensures that the ESM is managed in accordance with the ESM Treaty and the Statutes
- makes decisions as provided in the ESM Treaty or as delegated by the Board of Governors
- the EC and the ECB may participate in their meetings as observers

Managing Director:

- appointed by the Board of Governors for a period of 5 years
- directs the MEDE staff and current work under the direction of the Board of Directors
- chairs the meetings of the Board of Directors and participates in those of the Governing Board
- is the chief of staff and legal representative of the MEDE

Board of Auditors:

- is an independent oversight body made up of five members
- are appointed by the Board of Governors on the proposal of the Chairman of the Board of Governors, the Supreme Audit Institutions of the ESM members on a rotating basis and the European Court of Auditors
- inspects the accounts of the ESM and verifies that the operating accounts and balance are in order
- prepares annual reports with respect to ESM financial statements



BOARD OF GOVERNORS
BOARD OF AUDITORS
BOARD OF DIRECTORS
BOARD RISK COMMITTEE
BUDGET REVIEW AND COMPENSATION COMMITTEE
MANAGING DIRECTOR
MANAGEMENT BOARD
FINANCE COMMITTEE
INTERNAL RISK COMMITTEE
INVESTMENT MANAGEMENT COMMITTEE
CORPORATE PROJECTS COMMITTEE
BANKING COMMITTEE
INCIDENT MANAGEMENT TEAM

	European Financial Stability Facility EFSF	European Stability Mechanism ESM
Legal Structure	Private company under Luxembourg law	Inter-governmental institution under international law
Duration	June 2010-June 2013 No new programmes from 1 July 2013	Permanent institution
Capital structure	Backed by guarantees of euro area Member States	Subscribed capital of €704.8bn* €80.55bn in paid-in capital €624.3bn in committed callable capital
Maximum Lending capacity	€192bn committed for Ireland, Portugal & Greece	€500bn
Creditor status	Pari passu	Preferred creditor status (after IMF) **
Credit Rating	AA (negative) / Aa1 (stable) / AA (stable)	- / Aa1 (stable) / AAA (stable)

FINANCING

- The ESM raises money by issuing bonds (debt instruments with maturities of up to 30 years) and bills (up to one year)

- ESM issues are backed by € 80 billion of paid-up capital by Member States and € 620 billion of callable capital

- Bonds and bills issued by EFSF and MEDE are bought by institutional investors, such as commercial banks, central banks and investment funds

- The ESM does not lend taxpayer money to beneficiary countries, only funds raised through the sale of bonds and bills

PAID-IN CAPITAL
80 BILLION EUROS

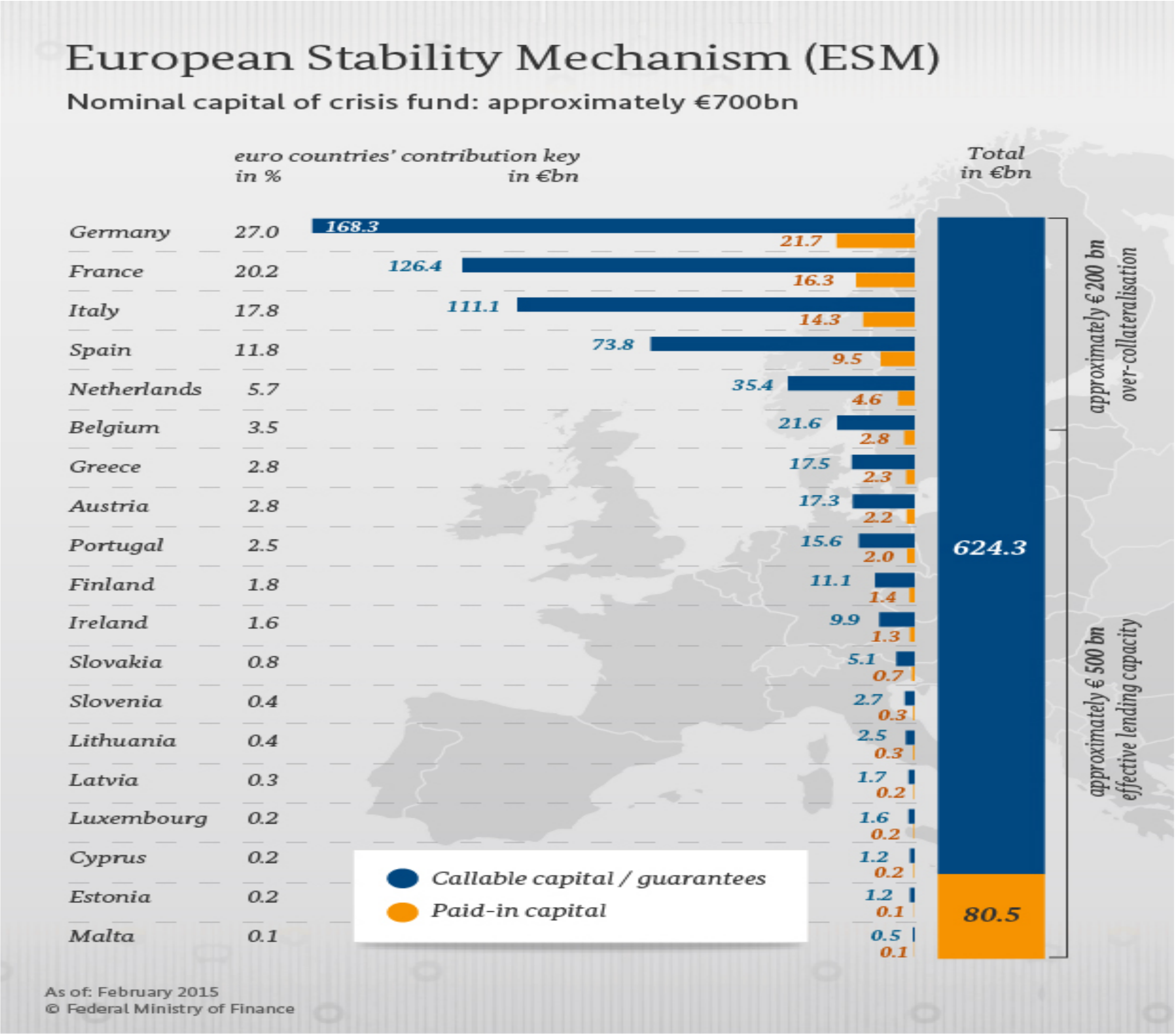
- Not available for loans
- To protect bondholders
- Prudent and conservative investment policy

CALLABLE CAPITAL COMMITTED 625 BILLION EUROS

- Emergency capital call → Emergency capital calls can be made to avoid default on any MEDE payment obligation

- Capital call to restore the level of paid-in capital → The Board of Directors of MEDE may make a capital call to restore the level of paid-up capital if it is reduced due to loss absorption

- Call for general capital → The Board of Governors of the ESM can request capital at any time


European Stability Mechanism (ESM)
Nominal capital of crisis fund: approximately €700bn
euro countries' contribution key
in %
in €bn
Total
in €bn
Germany 27.0 168.3 21.7
France 20.2 126.4 16.3
Italy 17.8 111.1 14.3
Spain 11.8 73.8 9.5
Netherlands 5.7 35.4 4.6
Belgium 3.5 21.6 2.8
Greece 2.8 17.5 2.3
Austria 2.8 17.3 2.2
Portugal 2.5 15.6 2.0
Finland 1.8 11.1 1.4
Ireland 1.6 9.9 1.3
Slovakia 0.8 5.1 0.7
Slovenia 0.4 2.7 0.3
Lithuania 0.4 2.5 0.3
Latvia 0.3 1.7 0.2
Luxembourg 0.2 1.6 0.2
Cyprus 0.2 1.2 0.2
Estonia 0.2 1.2 0.1
Malta 0.1 0.5 0.1
624.3
80.5
approximately € 200 bn over-collateralisation
approximately € 500 bn effective lending capacity
Callable capital / guarantees
Paid-in capital
As of: February 2015
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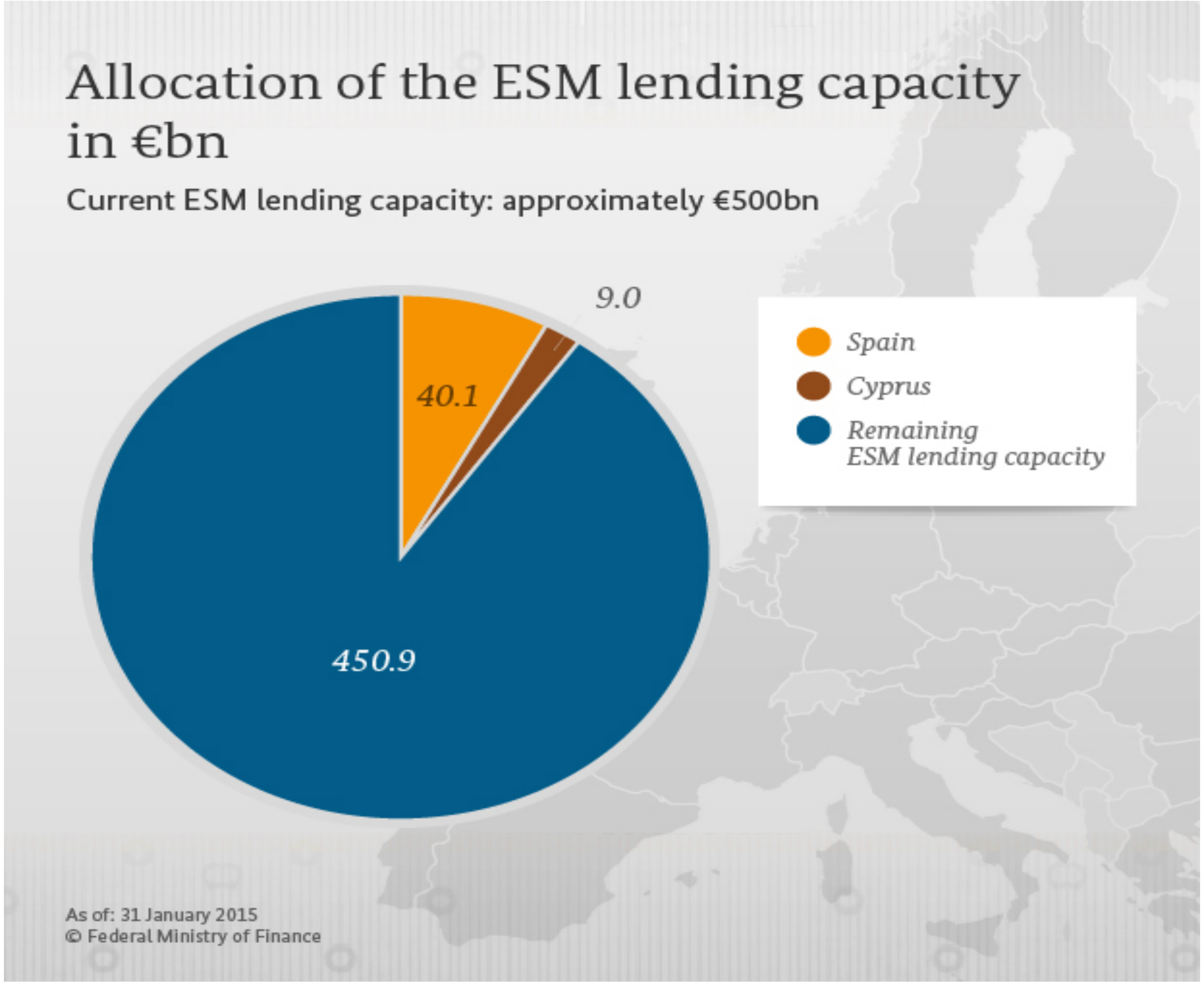
Allocation of the ESM lending capacity in €bn
Current ESM lending capacity: approximately €500bn
9.0
40.1
450.9
Spain
Cyprus
Remaining ESM lending capacity
As of: 31 January 2015
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ESM INSTRUMENTS

- Loans to States that are in a situation of serious financing problems or are at high risk of them

- Purchase of the bonds of a member country of the Eurozone in the primary and secondary debt markets

- Provide preventive financial aid in the form of lines of credit

- Financial recapitalization of financial institutions based on loans conceived to the governments of their member countries

FINANCIAL INSTITUTIONS RECAPITALIZATION (I)

On 8 December 2014, the ESM Board of Governors adopted the ESM direct recapitalization instrument for financial institutions in the euro area.

Eligibility requirements

1. <u>Member State:</u>

- Unable to rescue without adverse effects on fiscal sustainability and market access
- Aid must be essential to protect the financial stability of the euro area or its Member States

2. <u>Bank:</u>

- Capital requirements likely not met
- Viability depends on capital injection and restructuring
- Unable to attract sufficient capital from private sources
- Systemic or selective threat to financial stability

FINANCIAL INSTITUTIONS RECAPITALIZATION (II)

- Due diligence and thorough economic valuation are prerequisites

- Limit: 60 billion euros

- Amount for direct recapitalization by the ESM

- Conditionality → bank specific rules and policy conditions for the requesting Member State

- Possible retroactive application → is decided on a case-by-case basis according to the unanimity rule

ESM FINANCIAL ASSISTANCE CONDITIONS

All forms of ESM financial assistance are linked to appropriate conditionality: to receive assistance, beneficiary countries must implement a set of reforms.

Beneficiary countries that receive loans from the ESM must implement a macroeconomic adjustment program that generally covers reforms in the following areas:

- Fiscal consolidation
- Structural reforms
- Financial sector reforms

For other ESM financial assistance instruments, beneficiary countries must meet specific criteria for each type of instrument.

The "Troika" periodically carries out the evaluation of compliance with the conditionality of the policies.

A positive assessment is necessary for the ESM to approve and disburse successive tranches of financial assistance.

RISK MANAGEMENT (I)

- Given the institutional mission, ESM Risk Management focuses on:
  - Monitoring of credit activities
  - Manage the investment portfolio to ensure that the required credit quality and liquidity are maintained
  - Continue to monitor market risk trends to provide adequate information to decision makers
  - Support the preservation of capital
  - Reduce the potential risks of operations and compliance
- EFSF and MEDE are "first of its kind" organizations, therefore the risk function had to be built following best governance practices
- EFSF and MEDE do not regulate, but are open to the market and are highly monitored

RISK MANAGEMENT (II)

- MEDE Treaty, art. 13: "The ESM shall establish an appropriate alert system to ensure that it receives the reimbursements due from the ESM Member under stability support and in a timely manner."

- The ESM terms and conditions on capital applications (under Article 9.2 and 9.3 of the ESM Treaty) require the Internal Risk Committee to form an opinion on the financial situation of a borrower and assess the planned repayment schedule against possible scenarios.

- In order to address this requirement, the ESM has developed an Early Warning System, with ad hoc reporting, decision making, and escalation processes.

HOW DOES THE ESM FIT INTO THE GLOBAL RESPONSE OF THE EURO AREA?

1. Significant fiscal consolidation and structural reforms at the national level
2. Improve the coordination of economic policies in the European zone
3. Monetary policy measures
4. Strengthening the banking system
5. EFSF and MEDE

MEDE REFORM (I)

The European Commission's proposals to create a European Monetary Fund to replace the ESM were published in December 2017.

On November 30, 2020, the finance ministers of the Eurogroup agreed to modify the treaties that establish the format of the ESM and the Single Resolution Fund, which has been ratified in 2021 by all the Member States of the Eurozone.

The proposed amendments include:

- The establishment of the ESM as "support" of the Single Resolution Fund
- Governance reform of the ESM
- Precautionary financial assistance instruments
- Clarifications and extensions of the ESM mandate on economic governance

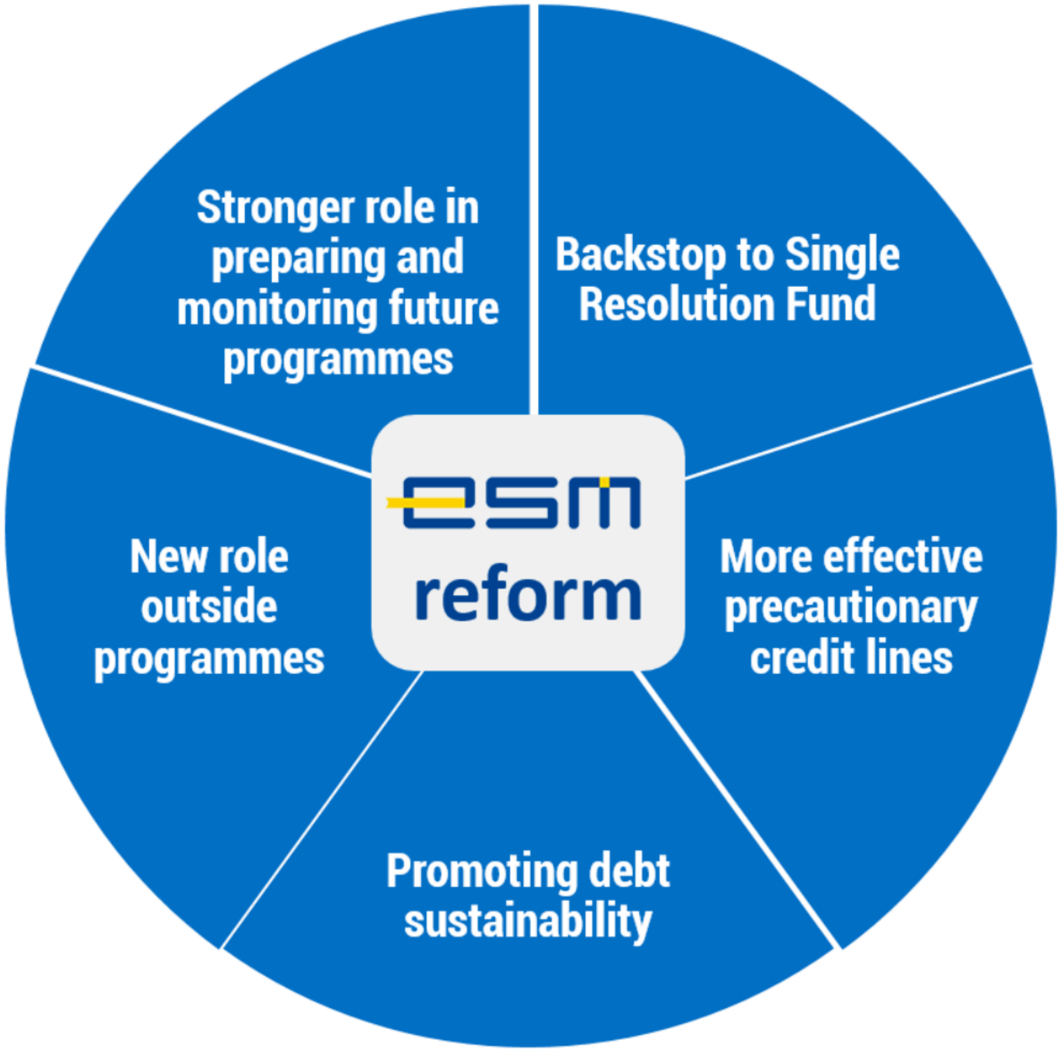
MEDE REFORM (II)

Seek to increase the effectiveness and flexibility of the European Stability Mechanism.

Expand its mandate by providing it with new functions and responsibilities:

- have a more accessible precautionary line of credit
- a common support mechanism for the Single Resolution Fund will act through a line of credit from the beginning of 2022
- it will play a bigger role in financial assistance programs and crisis prevention. In collaboration with the European Commission, the ESM will design, negotiate and monitor future assistance programs

Together with the early introduction of the common budget backstop, this will help ensure that the euro area is able to cope with emerging challenges.


Stronger role in preparing and monitoring future programmes
Backstop to Single Resolution Fund
New role outside programmes
esm
reform
More effective precautionary credit lines
Promoting debt sustainability

EUROPEAN STABILITY MECHANISM AND COVID-19 (I)

- The ESM offered fiscal shock plans to the current coronavirus crisis and has agreed to reactivate the bailout mechanism with an immediate capacity of 240 billion euros (May 2020) - loans equivalent to 2% of its Gross Domestic Product

- The start-up through the ESM's "preventive credit line" available to all euro states, allowing the erection of a "wall of protection"

- The only conditionality associated with this line is that the Member State allocate the funds received to cover eligible expenditure, and the enhanced supervision of the Commission would focus on the destination of the funds

- Available in principle till the end of 2022

EUROPEAN STABILITY MECHANISM AND COVID-19 (II)

- No country accepted the loan (see Next Generation EU - 750 billion euros)

- Un-utilized lending capacity of € 410 billion, which is around 3.4% of euro area GDP

- The use of the ESM as the first line of fiscal defence was the preferred option for rich euro countries such as the Netherlands or Germany, while southern partners such as Spain or Italy promote the Eurobond route, although so does the Central Bank European (ECB)

CONCLUSIONS

- Financial stability in Europe requires multi-layered institutions
- Additional capacity should be framed through regulation and prudent credit growth
- The resolution mechanisms offer a flexible tool that can be adjusted for specific purposes or expanded according to requirements
- The political and social impact of crises requires strong governance with checks and balances
- Risk management of a resolution mechanism involves a new combination of tasks and roles
- Communication channels between different institutions in Europe are essential for monitoring and action

This Jean Monnet Module has obtained co-financing from the European Union through the Erasmus + Program

Call for Proposals: 2020 – EAC-A02-2019-JMO

Reference: 620595-EPP-1-2020-1-ES-EPPJMO-MODULE

UNED

With the support of the Erasmus+ Programme of the European Union