

COMPREHENSIVE REVIEW OF THE MAXIMUM LENDING VOLUME, ADEQUACY OF THE AUTHORISED CAPITAL STOCK AND FINANCIAL ASSISTANCE INSTRUMENTS

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Executive Summary

The ESM staff has prepared the final report on the comprehensive review of the ESM's lending volume, capital adequacy, and financial assistance instruments, which follows an interim report, presented to ESM Members in June 2023. While the staff findings and conclusions are being put forward for consideration of the ESM Boards for the first time, feedback received from Members on the interim report and over the course of 2023 were taken into account when drafting the final report. The mandate to carry out the review came from the Board of Governors (BoG), who on 16 June 2022, in the context of the regular quinquennial review of the ESM's maximum lending volume and authorised capital stock, agreed for the ESM staff to carry out a more comprehensive review – to be completed by the first quarter of 2024 – also covering the ESM financial assistance instruments. The report was initiated assuming the entry into force of the revised ESM Treaty by the end of 2023. In the absence of a full ratification by then, the findings of the comprehensive review also take into account the ESM toolkit under the existing Treaty. The comprehensive review considers the experience from past crises, the latest economic and financial outlook, and the evolving euro area economic governance framework.

The objective of the report is to assess whether the ESM financial assistance instruments and lending capacity remain fit-for-purpose in serving ESM Members and the euro area while using the revised or existing ESM Treaty to their full potential. The report is also meant to serve as a recap of the various ESM instruments and to engage in earnest with Members in discussions on whether improvements are needed in light of the prevailing risks and various regional and global challenges, similar to the recently concluded review of the IMF's precautionary facilities (IMF 2023). Furthermore, it also analyses the impact of the recently agreed reform of the EU's economic governance framework on the ESM instruments.

Successive crises since 2010 have shown that, despite its increased resilience, continuous reinforcement of the euro area safety net is warranted to protect against large shocks. This is especially true considering increased debt levels and more frequent occurrence of external threats to financial stability in recent years, and potential future challenges, including climate change, ageing and geopolitical developments. The euro area responded decisively to recent challenges, yet it also relied on temporary tools, some of which have led to an unprecedented increase in liabilities and/or have been exhausted. One of the key lessons from past crises is that a timely and effective response to adverse shocks is essential and preventing crises is less costly than resolving them. A credible crisis prevention and resolution mechanism internalises lessons from experience. Detecting risks early and being ready to act effectively and on time is at the core of the ESM, which remains the only permanent euro area institution with a mission exclusively dedicated to preventing and resolving financial crises and to safeguarding the euro area's long-term financial stability. It is therefore critical to take stock of its stability support instruments and lending capacity to ensure the ESM's readiness to respond to future shocks.

The report offers the following key findings, which are meant to provide a basis for follow-up work:

- 1. The ESM loan instrument has been the most utilised instrument in the ESM toolkit. The elements agreed as part of the ESM reform further enhance its relevance, efficiency, and effectiveness.*
- 2. ESM precautionary instruments remain key for the ESM's crisis prevention role, which is likely to be increasingly relevant in the context of a shock-prone regional and global environment. Crisis prevention is less costly than crisis resolution as it allows for providing stability support early to limit negative spillovers and prevent contagion. Yet, the experience during the Covid-19 pandemic, confirmed by ESM Members' feedback, shows that the ESM pandemic support was not accessed due to political stigma, prevailing low borrowing costs, and instruments provided by European institutions, which supported sovereign market access during that period.*

ESM precautionary instruments could become more effective after addressing the issue of political stigma, which could be achieved by enhancing the role of confidential consultations and enabling group requests for assistance.

Moreover, following the agreement on the reform of the Economic Governance Framework, there is a need to analyse its impact on the revised ESM precautionary instruments' eligibility criteria. An alignment would be warranted to maintain consistency of the revised precautionary instruments with the European fiscal rules.

Finally, ESM precautionary instruments, which primarily function as insurance, could be used and adapted to address emerging risks. The existing and revised Treaties also include the possibility to create a dedicated instrument, which would facilitate lending for specific purposes during a shock. This would preserve financial stability while avoiding further increases in Members' liabilities and costs. It would also address political stigma associated with ESM support through improved signalling and a greater preventive role.

- 3. The ESM's Primary Market Support Facility (PMSF) and the Secondary Market Support Facility (SMSF) remain important as they have a strong impact on market expectations, which derives partly from their close links to ECB policy instruments.*
- 4. The role of the ESM indirect bank recapitalisation instrument (IRI) has been impacted by the evolving EU regulatory and supervisory landscape and development of banking union. The banking union framework was not in place when the instrument was designed and used. Nevertheless, the instrument remains sufficiently versatile and potentially relevant in addressing new sources of risk.*

In the context of banking union, the IRI can complement the existence of the Single Resolution Fund (SRF) and the common backstop. The IRI can be effective in addressing systemic issues affecting simultaneously different financial institutions, possibly across multiple Members. Under the current EU legal framework, the IRI could be used at an early stage of financial sector distress to finance precautionary recapitalisation. This is subject to the final outcome of the crisis management and deposit insurance (CMDI) framework reform, which may further limit the scope of such recapitalisations. Finally, the IRI could be considered as an effective tool for addressing emerging risks to financial stability due for instance to climate change. The potential scope for addressing vulnerabilities in non-bank financial institutions appears to be

limited, yet it should not be dismissed given an increasing size of the sector and its interconnectedness with other segments of the financial system and the real economy.

5. *As regards the common backstop, the SRF's size has grown larger than anticipated at the time of the ESM reform, while the then agreed framework provides for the possibility to adjust the size of the backstop, if needed. Any discussion on increasing the nominal cap under the backstop could take place after the entry into force of the revised ESM Treaty and would need to consider that the ESM's lending capacity must remain adequate to support both the euro area sovereigns and the banking system.*

The common backstop is expected to replace the direct bank recapitalisation instrument (DRI). Yet, if the revised ESM Treaty does not enter into force in the course of 2024, a review of the DRI guideline should be performed to prepare a decision on its continuation.

6. *The ESM's maximum lending volume has supported euro area financial stability up to now while a significant amount of the lending capacity remains available for emerging financial stability threats. Since the ESM's firepower has been kept unchanged since inception, a slight decline can be expected relative to the main macroeconomic aggregates. At the same time, the improved overall safety net for the euro area, regulatory provisions, and ongoing efforts to pursue further advances through the capital markets and banking union may reduce the need to use the ESM's lending capacity. The ESM's maximum lending volume and authorised capital stock remain adequate at present.*

Background and outline

According to the ESM Treaty, the Board of Governors (BoG) reviews regularly and at least every five years the maximum lending volume and the adequacy of the authorised capital stock of the ESM.¹

The BoG also reviews the list of financial assistance instruments and decides whether to make changes to it. At the Annual Meeting of 16 June 2022, the BoG decided to maintain the ESM's maximum lending volume and authorised capital stock constant, thereby concluding the mandatory five-year review. Due to the uncertain economic environment and related factors that were difficult to fully take into account in that exercise, the BoG agreed for the ESM to carry out a comprehensive review of the maximum lending volume and the authorised capital stock by Q1 2024. This also included a review of its financial assistance instruments, as provided for by the ESM Treaty. An interim report was presented in June 2023, when Members agreed that the ESM should proceed with its work on the comprehensive review.

In October 2023, the Eurogroup President reported on the Eurogroup's readiness to "collectively reflect on the future role and tools of the ESM" following the ratification of the revised Treaty.² In December 2023, the Italian Parliament voted against the revised Treaty's ratification. Hence, this report provides the basis for the reflection on the ESM's role under the revised and the existing Treaty, which remains in force.

This final report is structured as follows. Section 1 provides a broader context for the comprehensive review, highlights some emerging risks and reflects on the evolution of the euro area crisis management. Section 2 includes the assessment of the ESM financial assistance instruments. Subsection 2.1 covers an assessment of the loan instrument. ESM precautionary instruments including the experience of the Pandemic Crisis Support are considered in Subsection 2.2. Subsection 2.3 considers the market support instruments, and Subsection 2.4 the indirect recapitalisation instrument. Subsection 2.5 focuses on the implications of the common backstop size on the ESM's lending capacity. Section 3 offers an analysis of the adequacy of the ESM's lending capacity, considering the findings from the preceding sections. Final remarks are provided in Section 4.

This report reflects the views of the ESM staff, was approved by the Managing Director, and takes into account the mandate as envisaged under the revised and existing ESM Treaties. The differences between the current and the enhanced mandate are highlighted where relevant for the analysis.

¹ Article 10 of the ESM Treaty: "The Board of Governors shall review regularly and at least every five years the maximum lending volume and the adequacy of the authorised capital stock of the ESM."

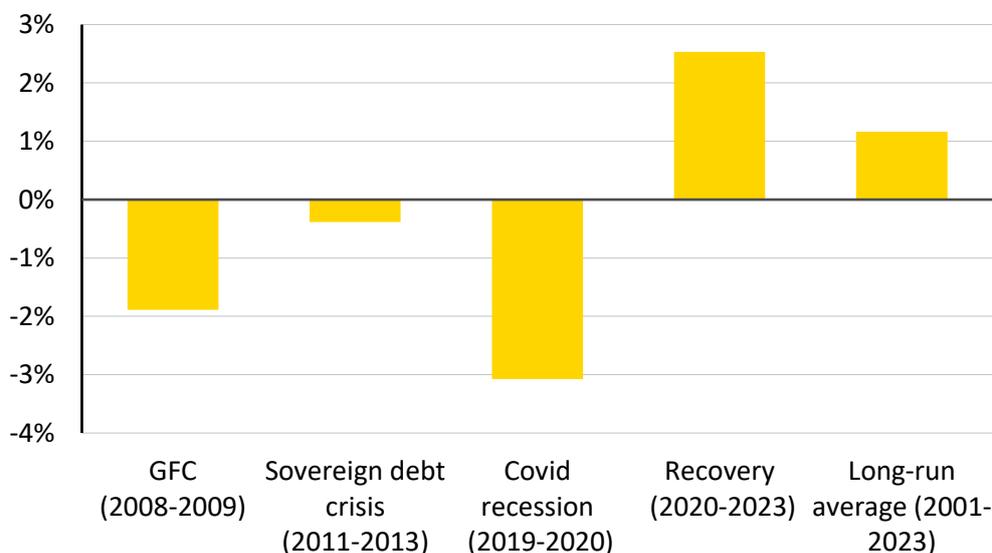
² As stated in the letter dated 20 October 2023 from the President of the Eurogroup to the President of the European Council, available at <https://www.consilium.europa.eu/media/67536/peg-to-pec-letter-october-2023.pdf>

1. Introduction

Since 2008, economic stability in the euro area and the effectiveness of its governance framework have been challenged by large shocks (Figure 1). The 2008 global financial crisis and the ensuing euro area sovereign debt crisis exposed the lack of adequate crisis resolution capacity in the euro area. At the height of the financial market turmoil, national policy responses had to be complemented by new euro area interventions. As the crisis threatened to spill over into other economies of the monetary union, it became clear that a robust structure for crisis management was needed to reassure the markets.

Figure 1.

Compound annual growth rate of real GDP, euro area



Source: Eurostat

Note: Euro area in rolling composition

In late 2010, the euro area member states decided to establish a permanent crisis resolution institution, the ESM, which became operational in October 2012. The ESM reinforced the euro area crisis management architecture through a more robust institutional and capital structure. Unlike previous support instruments which relied on either the EU budget or national guarantees, the ESM capital structure uses both paid-in and callable capital to ensure a high and robust creditworthiness. With its lending capacity of €500 billion, which was deemed sufficient to instil confidence in the euro area's crisis resolution capacity at the time, the ESM replaced the temporary European Financial Stability Facility (EFSF). In August 2012, the European Central Bank announced the introduction of a new instrument – the Outright Monetary Transactions (OMT) - to support euro area member states with limitless firepower conditioned on certain types of financial assistance programmes by the ESM.

In addition to the establishment of the ESM and the new ECB tools, important elements of banking union were introduced to ensure the financial stability of the currency union. The Single Supervisory Mechanism (SSM) was set up as the first pillar of banking union to ensure independent supervision of the euro area banking system. The second pillar was the establishment of the Single Resolution Mechanism (SRM) to address the sovereign-bank nexus by enabling orderly resolution of failing banks

while shielding taxpayers from state bailouts. The creation of a common backstop to the Single Resolution Fund (SRF) was agreed in principle in 2013 and will be implemented after entry into force of the revised ESM Treaty.

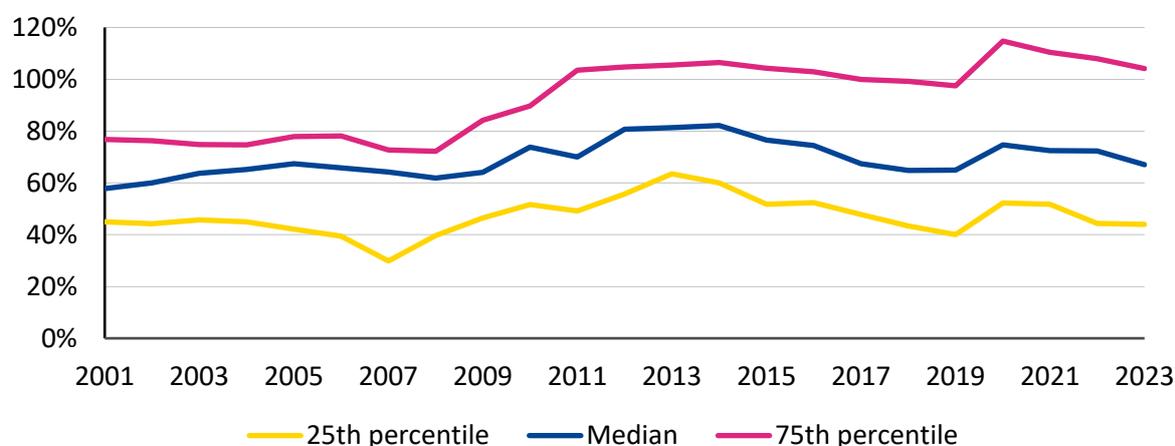
The EU was quick to react when the Covid-19 pandemic crisis struck in early 2020. The pandemic caused a new economic downturn, which required Europe-wide crisis mitigation. The immediate safety nets introduced in May 2020 were provided by the European Commission, the European Investment Bank, and the ESM. The emergency package of €540 billion was designed to support firms, households, and governments. It came on top of support measures provided at national level. It included the ESM's Pandemic Crisis Support (PCS) credit line, designed to support euro area member states in financing healthcare costs related to the Covid-19 crisis, as well as the Commission's instrument for temporary Support to mitigate Unemployment Risks in an Emergency (SURE). At the same time, the ECB expanded the targeted, longer-term, refinancing operations (TLTROs) and deployed the new Pandemic Emergency Purchase Programme (PEPP). These initiatives provided EU Member States time to agree on an EU-wide scheme, the Next Generation EU (NGEU). The Recovery and Resilience Facility (RRF), a key part of the NGEU, was designed to support the post-pandemic recovery and digital and green transitions with a multi-year investment programme. The RRF is a temporary instrument, which initially made available over €700 billion (of which €338 billion in grants) to Member States³. As of 30 May 2024, a total of €148.69 billion in grants and €84.15 billion in loans had been disbursed to EU countries.⁴ In 2022, in response to the global energy market disruption caused by Russia's war on Ukraine, the European Commission implemented its REPowerEU plan, allowing to fund member state responses through various existing sources, notably the RRF. All RRF disbursements shall be made to Member States until 31 December 2026 and discussions remain ongoing to identify financing sources to repay its grant components.

The fiscal and financial packages to address the economic consequences of the pandemic were largely successful in avoiding losses to employment and preserving financial stability but coincided with a further fiscal divergence inside the euro area. Public interventions were able to address liquidity shortages and thereby prevented more significant solvency issues. The euro area economy recovered much faster from the pandemic than from the global financial and sovereign debt crisis. This is inherent to the deep, yet short-lived nature of the shock and a consequence of the comprehensive, well-coordinated and rapid support provided. Even so, euro area member states exited the pandemic crisis with varying degrees of resilience. Their economies have become more divergent in terms of public debt (Figure 2). The Covid response contributed to an overall increase in euro area member states' debt levels. These volumes remain high, given insufficient debt consolidation prior to the crisis. This divergence adds to the vulnerability of all member states, as prolonged difficulties in one or a few countries can have adverse spillover effects on others and threaten the euro area economic stability.

³ Note: the total financial envelope of the RRF at the end of 2023 stood at €648 billion. This breaks down into €357 billion in grants and €291 billion in loans. Information last updated on 11 March 2024 under [Recovery and Resilience Scoreboard \(europa.eu\)](https://ec.europa.eu/economy_finance/recovery-and-resilience-scoreboard/europa.eu).

⁴ Based on the RRF Scoreboard available at https://ec.europa.eu/economy_finance/recovery-and-resilience-scoreboard/disbursements.html?lang=en

Figure 2.
Distribution of euro area member states' public debt ratios



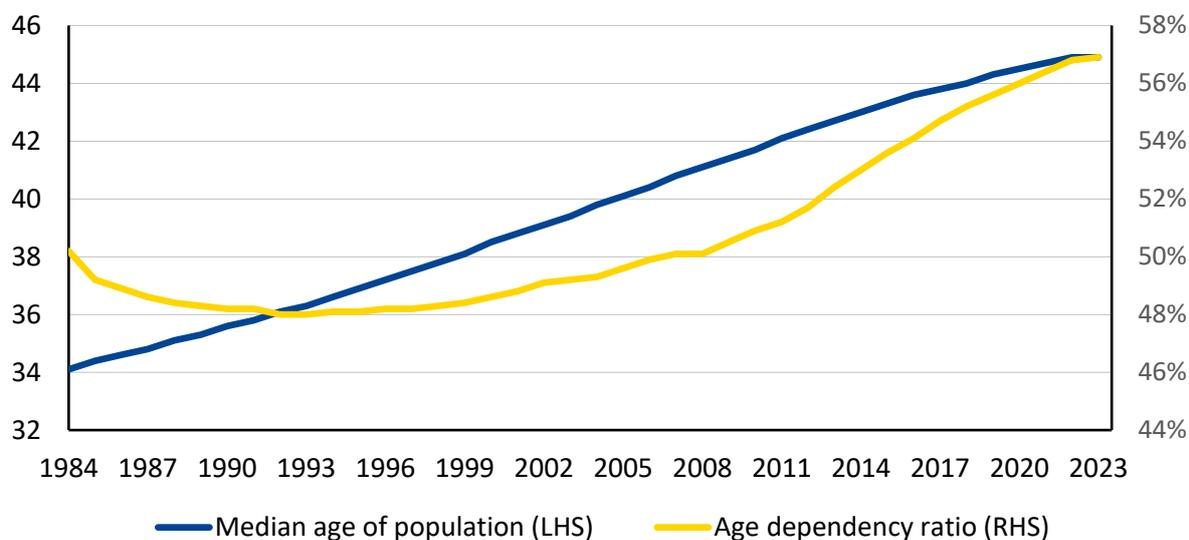
Source: European Commission, AMECO database

Note: Euro area in rolling composition

Today, national budgets and euro area crisis management are again being tested by various types of crises. Following the Covid-19 pandemic, the recovery of European economies was cut short. Russia's war on Ukraine drove up prices for energy, metals, and agricultural commodities. The EU and its Member States responded with efforts aimed at stabilising demand and reducing supply-chain dependencies. At the same time, monetary policy became restrictive as inflation had reached levels not seen in decades. Rapid increases in market interest rates and the uncertain growth outlook raised concerns over the stability of public and private sector debt. Most recently, this insecurity has been reinforced by growing hostilities in the Middle East and military attacks on important shipping lanes, which could further aggravate geopolitical tensions and add to price volatility.

Economic crises are reminders that despite its increased resilience, the euro area, to some extent, remains vulnerable to future large shocks. The ongoing fragmentation of the world into multiple and sometimes rival powers raises new risks to financial stability associated with a higher likelihood of conflicts, elevated security spending, and a reduction in trade and capital flows, spurred also by protectionist impulses. These risks come on top of precarious secular trends and a climate crisis, exposures to which are likely to become highly asymmetric (Alogoskoufis et al., 2021). Population ageing, which reduces the number of contributors to the welfare state and raises health expenditure (Figure 3), the rise of new technologies, including the rapid advances in artificial intelligence posing social challenges potentially also for employment, and further geopolitical risks may all be sources of important shocks in the near future.

Figure 3.
Euro area demographic dynamics



Source: Eurostat

Note: age dependency is measured as the ratio of population aged 0-14 and 65+ to population aged 15-64.

Acute climate-related risks may impact many sectors, including notably the financial system. Both physical risks and uncertainty tied to transition pose the potential for enhanced volatility within the euro area financial infrastructure, with possible effects propagating via numerous channels.⁵ ESM staff are continuing to contribute to the collective understanding of how these risks are likely to manifest and pass through to financial stability.⁶ These are the main takeaways:

- **Output losses and reduced growth prospects:** More frequent and extreme weather events could generate large economic losses and reduce production capacity by destroying human and physical capital and reducing productivity growth.
- **Worsening public sector balance sheets:** Large expenditures could emerge from disaster relief, reconstruction, and recovery, as well as the materialisation of contingent liabilities. Beyond the climate mitigation expenditure burden, foregone tax revenue from activity disruptions and diminishing carbon-intensive sources could generate an additional strain on public finances.
- **Deteriorating corporate and financial sectors balance sheets:** Both physical and transition risks could cause large and sudden re-evaluations of the assets of financial and non-financial firms. Notably, the insurance sector will be tested as claims rise, given the increased frequency and magnitude of natural catastrophes.⁷

⁵ From Basel Committee on Banking Supervision (2021): Certain economic sectors will have greater sensitivities to acute climate related physical risks or to the transition to a low-carbon economy. These climate-related events and risks are uncertain and may be subject to non-linearities. Credit risks may manifest through both income (reduced ability to repay debts) and wealth effects (capital value erosion affecting recovery rates). Market risks could propagate through sharp reductions in financial asset values and liquidity risks through reduced market conditions, such as via credit line and deposit drawdowns from counterparties. Operational, and reputational risks from increased scrutiny, expectations and market sentiments associated with the transition may equally contribute to further volatility.

⁶ See [ESM 2023](#) for a discussion on how Regional Financial Arrangements contribute to fight climate change consequences.

⁷ [Swiss Re \(2021\) estimates that natural catastrophes caused USD 105 billion in global insured losses in 2021, the fourth highest since 1970.](#)

- **Adverse effects on trade balances:** Export of goods from sectors sensitive to physical risks, like agriculture and tourism, are particularly exposed to climate change. Furthermore, euro area member states for whom commodities represent an important share within imports, could face higher food and energy prices due to disruptions in global value chains, falling agricultural production, and emission mitigation policies.
- **Weakening social fabric and worsening inequality:** A ‘crisis multiplier’ effect could emerge from rising temperatures and associated natural disasters, impairing access to basic needs such as food, fresh water, and habitable ambient temperature, which could trigger migration flows and aggravate social conflicts. Actions to limit global warming could increase inequality, hitting harder low-income households that spend a larger share of their income on energy and food while they tend to contribute the least to global emissions.

Being ready to quickly react to address euro area crises is at the core of the ESM, which remains the only permanent euro area crisis management fund. The ESM has significant lending capacity available for crisis response. Its mission is to safeguard the financial stability of the euro area as a whole and of its Members. Over the past decade, the ESM has demonstrated the capacity and agility in tackling crises in a cooperative and complementary manner. During the Covid-19 crisis, new EU instruments and budget allocations were introduced to counter growing risks. SURE and NGEU have proven successful in dealing with economic shocks but remain temporary in nature. The Commission would likely require additional resources to initiate another pandemic-type crisis response today. Under tighter financing constraints, even the interest costs of existing programmes required it to ask for a substantial top-up to the EU’s 2021-2027 budget in October 2023. In July 2022, the ECB announced the Transmission Protection Instrument (TPI) to contain unwarranted negative market dynamics during monetary policy normalisation.⁸ In addition, the ECB has used reinvestments of the PEPP to counter market fragmentation. The ECB with its instruments has played a critical role. However, it is not the lender of last resort for euro area sovereigns, the use and existence of its instruments is determined by monetary policy considerations and remains a prerogative of a fully independent central bank. It is therefore critical to take stock of the ESM stability support instruments, capital adequacy and lending capacity to ensure the ESM’s readiness to mitigate future crises, including in conjunction with other institutions.

⁸ Unlike OMT, the TPI is not linked to an ESM programme, hence TPI eligibility criteria do not include access to ESM stability support. Together with the European Commission, however, the ESM’s assessment of Members’ debt sustainability provides an input to the potential activation of the TPI.

2. Review of ESM financial assistance instruments

2.1 ESM loans

Loans with a macroeconomic adjustment programme have been the most utilised instrument in the ESM toolkit. They were used for past ESM programmes in Greece and Cyprus, as well as in Ireland, Portugal and Greece under the EFSF. This instrument was designed to support Members with material imbalances, significant financing needs, and that have, to a large extent, lost access to market financing. ESM loans are granted under strict conditionality contained in a macroeconomic adjustment programme detailed in a Memorandum of Understanding (MoU). Compliance with the agreed policy conditions by the beneficiary Member is subject to monitoring by the Commission, in liaison with the ECB and wherever possible with the IMF. Following the ratification of the revised ESM Treaty, MoUs of future programmes will be jointly signed by the Commission and the ESM. The ESM will also have an enhanced role in programme design and monitoring.

ESM loan facilities are so far clearly the most important and relevant instrument in the ESM toolkit.

By comparison, they are similar to the IMF's Stand-By Arrangement and Extended Arrangement under the Extended Fund Facility. The conditionality associated with ESM loans aims to restore fiscal sustainability, improve external competitiveness, and restructure banking sectors where there is a recapitalisation need in the context of a broader macroeconomic adjustment. In cases where vulnerabilities are limited to the financial sector only, assistance under an indirect bank recapitalisation instrument can be considered as was the case in Spain (see Section 2.4).

The ESM demonstrated its ability to amplify the stabilising role of its loans. In addition to providing loans, the ESM also worked towards commonly agreed solutions, such as the debt relief package for Greece endorsed by the Eurogroup in December 2016. These measures were designed to stabilise Greek loan interest rate volatility and reduce the risk that Greece would have to pay a higher interest rate when market rates increased. These included, for example, an extension of the EFSF repayment profile, exchanging its floating-rate notes for fixed-rate notes, and entering into swap arrangements.

The experience with ESM loans has been thoroughly considered in the ESM reform process, for which the findings of the first independent evaluation also provided an important input. The first evaluation, conducted under the auspices of Gertrude Tumpel-Gugerell and published in June 2017, drew lessons from the cross-country experience in Ireland, Portugal, Spain, Cyprus, and Greece up to the end of 2014. The second evaluation led by Joaquín Almunia was published in June 2020 and assessed the experience with the Greek programmes and the first year of the post-programme period in Greece up to September 2019. The evaluations found that while the use of loans with macroeconomic adjustment programmes contributed to the overall objective of restoring financial stability, there was scope to further increase the ESM's crisis prevention and preparedness capacity.

Members agreed in the context of the ESM reform, among others, to enhance the ESM's role in designing and monitoring the implementation of future stability support programmes, affecting all instruments including loans. Members agreed that the ESM should play a stronger role in assessing debt sustainability and that future Memorandums of Understanding with the beneficiary member state will be signed on the side of the institutions by the Commission and the ESM jointly, thus giving the ESM an enhanced role in programme design and monitoring. In this context, the ESM and the

Commission also agreed on their future cooperation and Members agreed to strengthen the ESM's preventive role by mandating it to follow macroeconomic and financial risks in the whole euro area, thereby addressing also key recommendations from the two evaluations. Furthermore, to prepare for its enhanced mandate and address other evaluation recommendations, the ESM carried out internal follow-up work which resulted in several important deliverables. These included, among others, expanding the analytical capabilities and setting up a review function to ensure consistency and even-handedness in country work and financial assistance provision, creating an online database of past ESM financial assistance programmes, and developing an internal tool to assess Members' administrative capacity to implement reforms in the context of a programme.

The ESM is prepared to fulfil the role foreseen under the revised Treaty for all instruments, including for loans. The internal preparations have focused on defining the approach and strengthening internal capacities and procedures for following the macroeconomic and financial risks in the euro area and its Members, as well as for designing, negotiating and monitoring conditionality in future financial assistance programmes. These internal preparations were completed, and the ESM is operationally ready to take on all tasks envisaged under the revised Treaty in providing loans.

Key findings

The ESM loan instrument has been the most utilised instrument in the ESM toolkit. The elements agreed as part of the ESM reform further enhance its relevance, efficiency, and effectiveness.

2.2 ESM precautionary instruments

The ESM Precautionary Conditioned Credit Line (PCCL) and the Enhanced Conditions Credit Line (ECCL) have been part of the ESM toolkit since its inception. These instruments were designed to help Members, whose economic conditions are still sound, maintain their continuous access to market financing. When granted either the PCCL or the ECCL, a Member will have access to a credit line for a limited period. The precautionary instruments are meant to function by both signalling the sound economic health of the beneficiary Member State and ensuring continued access to funding, if needed.

The ESM precautionary instruments were reviewed as part of the ESM reform and included in the European pandemic response when the Pandemic Crisis Support (PCS) credit line was created based on the ECCL framework. Still, precautionary instruments remain unused to date. This section includes the following: 1) an overview of the recent changes to the precautionary instruments, 2) an analysis of their relevance in today's shock-prone environment, 3) an analysis of the implications of the Economic Governance Reform, 4) a stock-taking of lessons learned from the PCS and 5) possible refinements to precautionary instruments to make them more effective drawing on these analyses.

2.1.1 The ESM precautionary instruments – background and ESM reform elements

ESM precautionary instruments provide temporary assistance to Members facing potential financial difficulties through signalling of sound policies and access to financing, if needed. ESM precautionary instruments are based on the premise that crisis prevention is less costly than crisis resolution. They limit negative spillovers and prevent contagion (IMF 2023). They are designed for Members whose economic conditions are sound but could face major difficulties in raising funds in the near future. The PCCL can be granted to Members that comply with all the eligibility criteria, whilst the ECCL can be granted when some of these criteria are not met if an agreement on corrective measures is made. These criteria are intended to provide a strong signal to the markets of the underlying sound policy standards maintained by the concerned Member. This in turn supports continuous access to market financing by strengthening the credibility of macroeconomic performance. These features help offset risks of severe welfare losses and spillovers whilst potentially mobilising fewer ESM resources compared to a fully-fledged macroeconomic adjustment programme. Further benefits may exist given the link with the ECB's OMT programme. OMT can only occur if the beneficiary Member State has agreed to an ESM macroeconomic adjustment or precautionary (ECCL) programme⁹.

Precautionary instruments can also be deployed to facilitate an exit from a macroeconomic adjustment programme. Such use can facilitate the assisted country in regaining market access due to the signalling of sound policies and financial backing. As noted in the ESM evaluation reports, precautionary credit lines were considered as exit strategies in past programmes. However, partly due to political stigma, the assisted countries ended up not requesting any follow-up arrangements and instead developed exit strategies mainly based on a build-up of cash buffers, even if they were more costly.

As part of the ESM reform, the precautionary instruments were revised to increase their transparency and predictability. The revised precautionary instrument guidelines aim to address a perceived lack of clarity on the instruments' conditionality and the ability of Members to reliably self-assess their eligibility ex-ante.¹⁰ This, coupled with the enhanced role in following macro-financial risks in the whole euro area, will further strengthen the ESM's crisis prevention role. The ESM reform modified some elements of the PCCL as presented in Table 1. Notably, some of the eligibility criteria will take the form of quantitative debt benchmarks reflecting the previous fiscal rules. The fiscal standard established for eligibility through these conditions is more clearly defined compared to that of the current guidelines which require compliance with fiscal rules in name. Furthermore, the PCCL will no longer require signing up to reform commitments in a MoU. Instead, a requesting Member shall commit to continuous compliance with the PCCL eligibility criteria and present its policy priorities in a Letter of Intent. As is the case under the current formulation of conditionality for precautionary assistance, such conditionality remains fully compliant with the requirements of "strict conditionality"

⁹ See ECB 2012 - Technical features of Outright Monetary Transactions: "A necessary condition for Outright Monetary Transactions is strict and effective conditionality attached to an appropriate European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) programme. Such programmes can take the form of a full EFSF/ESM macroeconomic adjustment programme or a precautionary programme (Enhanced Conditions Credit Line), provided that they include the possibility of EFSF/ESM primary market purchases."

¹⁰ See for example [Evaluation Report \(p60\)](#) on EFSF and ESM financial assistance programmes. According to some survey respondents, uncertainty on the type of conditionality they would face became a hurdle to making progress in domestic deliberations to request the precautionary instruments, specifically within the context of ESM programme exit.

under Article 3 of the ESM Treaty. Through this reform, PCCL assistance will now benefit from conditionality which better reflects its intended nature. The ECCL will remain unchanged.

Table 1.

Summary of the eligibility criteria in the revised Guideline for the precautionary instruments

Eligibility Criteria	Fiscal Policy Conditions	<ul style="list-style-type: none"> i. A general government deficit not exceeding 3% of GDP ii. A general government structural budget balance at or above the country- minimum benchmark¹¹ iii. A general government debt-to-GDP ratio below 60% or a reduction in the differential with respect to 60% over the previous two years at an average rate of one-twentieth per year
	EDP and EIP	No active Excessive Deficit Procedure or Excessive Imbalance Procedure to access the PCCL
	Other	<ul style="list-style-type: none"> A sustainable government debt and external position Track record of access to international capital markets on reasonable terms Absence of severe financial sector vulnerabilities
Policy commitments	<ul style="list-style-type: none"> PCCL - Letter of Intent – Commitment to respect eligibility criteria ECCL - MoU elaborated with the Commission and in liaison with the ECB, and where possible IMF 	

2.1.2 Is there a need for ESM precautionary instruments in today's shock-prone world?

ESM precautionary instruments could support Members facing an emerging or potential crisis and are key pillars of the ESM's crisis prevention role. Preserving fiscal space and market access remains the primary crisis prevention measure when faced with uncertainty. As new forms of shocks impact the real economy, both output and potential growth may be impaired whilst expenditure needs could rise substantially. Recent events such as the Middle East crisis and Russia's war on Ukraine and their asymmetric impact on euro area member states or the repeated bouts of climate-related events testify to the vulnerabilities generated by external shocks. Member states' ability to effectively address the consequences of these shocks diminishes as their fiscal space decreases, which in turn hampers the ability for crisis containment and poses risks of spillovers. As part of its mandate to preserve financial stability in the euro area, the ESM can provide assistance to ensure that an emerging risk does not develop into a full-blown crisis.

The precautionary instruments could prove to be an important safeguard in the context of the green transition. The nature of the expenditures required for the green transition is particularly challenging in light of investments needed over a long horizon and the low returns on these investments expected in the short-run as noted by Pisani-Ferry and Mahfouz (2023). Precautionary instruments could help temporarily safeguard fiscal space in times of stress and maintain the needed long-term fiscal planning in case of large shocks.

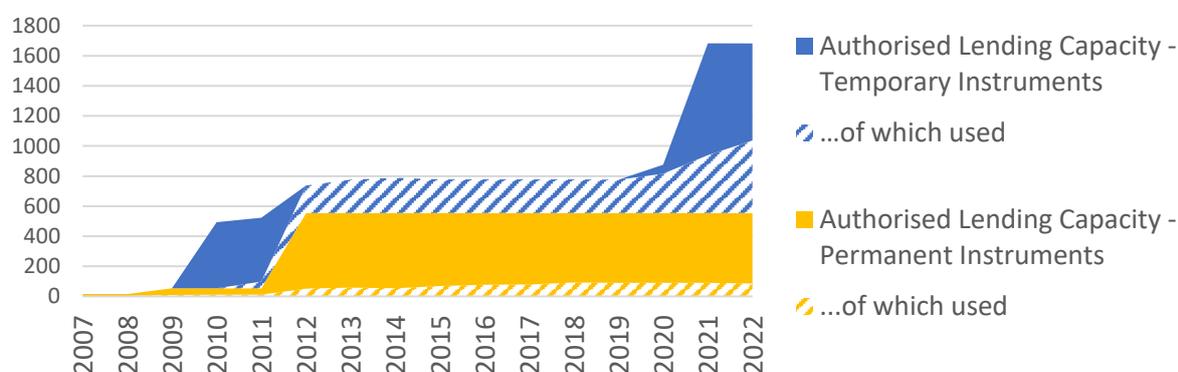
The legal framework of the precautionary instruments, under both the current and revised Treaty, allows for the use of precautionary instruments to address emerging challenges. The precautionary instruments framework does not outline a strict set of eligible shocks and risks, but rather identifies scenarios for which assistance could be warranted for ESM Members with sound underlying

¹¹ The minimum benchmark is the level of the structural balance providing a safety margin against the 3% budget deficit to GDP threshold established by the EU Treaties under normal cyclical conditions. It is mainly used as one of three inputs into the calculation of the minimum MTO.

economies.¹² Members facing severe potential funding difficulties can benefit from the precautionary instruments as a form of stability support. This access is subject to ex-ante conditionality in the form of compliance with criteria in the instrument guidelines (and in Annex III of the revised ESM Treaty once it has entered into force) as well as ex-post conditions. The revised ESM Treaty better recognises the instruments’ preventive nature through a greater emphasis on support for sound policies and prevention of crisis situations and by eliminating automatic reviews for adequacy or alternative assistance needs.

The cost efficiency of precautionary instruments compared to ad-hoc temporary instruments is an important consideration given the recent increase in sovereign support of common schemes. Since the onset of the Global Financial Crisis, member states have created both ad-hoc and permanent EU and euro area facilities to respond to common concerns such as resilience, development, and long-term growth. The amount of resources dedicated notably to temporary instruments has been increasing in recent years (see Figure 4). During the Covid-19 pandemic for example, a temporary increase of the EU budget headroom (0.6% of EU Gross National Income) was agreed to guarantee NGEU liabilities. As of 2022, total outstanding contingent liabilities generated through the EU, ESM and EFSF instruments as well as those liabilities stemming from NGEU and the RRF represented approximately 4.2% of the EU GDP. As future crises may emerge, the recourse to temporary initiatives outside existing frameworks would necessitate the provision of further guarantees for which there is a limited fiscal space. Upon expiration of the Covid-19 era temporary instruments in 2027, the ESM would remain the largest source of potential financing based on existing capital structures for its Members.

Figure 4
Authorised and realised contingent liabilities: Temporary and Permanent 2007-2022
 (in € billion)



Source: ESM, European Commission

Note: Authorised lending capacity refers to the maximum stock of outstanding liabilities an instrument can have under its own regulations. The instruments in this graph are those instruments in the EU and the euro area that have a set lending capacity and are funded through market operations. Authorised lending capacity and their usage are distinguished by whether the instruments are permanent (ESM, BoP, Euratom) or temporary (EFSF, SURE, RRF, NGEU, and EFSM). Other contingent instruments that either do not have a set limit or operate through budgetary guarantees are not included (EGF, MFA, EFSI, Invest EU, ELM, EFSD+). The contingent liabilities incurred directly from the EIB, the EBRD and other international financial institutions for which ESM Members are shareholders are not included in this graph.

¹² Access to the precautionary instruments is equally modulated to address concerns of moral hazard and permanent transfers.

Overall, ESM precautionary instruments remain relevant in the current shock-prone environment. Their further development should also consider the impacts of the reform of the Economic Governance Framework and lessons to be drawn from the ESM Pandemic Crisis Support experience, which are analysed in the following sections.

2.1.3 Implications of the reform of the EU's economic governance framework

In April 2024, the EU's new economic governance framework entered into force. This reform has consequences for access to the ESM precautionary instruments¹³ since the EU fiscal rules — which have been used as the basis to determine eligibility for the ESM precautionary instruments — have been modified. It is thus important to analyse the resulting impact on access to the ESM precautionary instruments. The reform of the fiscal rules will notably change the following elements, which are relevant for PCCL and ECCL eligibility under the revised ESM Treaty:

- **The 1/20th debt reduction rule will be abandoned in favour of a risk-based approach.** EU Member States would follow a country-specific debt-reduction path in the form of pre-agreed yearly net expenditure targets, subject to safeguards ensuring debt reduction when above 60% of GDP.
- **Unobservable variables will no longer be the operative variables.** The nationally financed net primary expenditure would serve as a basis for setting the fiscal adjustment path and carrying out annual fiscal surveillance while the output gap and the structural balance would no longer have a guiding role.¹⁴ The minimum structural balance, which is explicitly mentioned in the revised precautionary instruments guideline, will no longer exist.

After the revised ESM Treaty enters into force, it would be advisable to review the precautionary instruments' eligibility criteria to ensure their consistency with the reformed fiscal rules and to maintain the instrument's signalling power. As discussed in section 2.1.1., the definition of the PCCL eligibility criteria related to government finances will transition from a qualitative assessment to a quantitative one as part of the ESM reform (see also table 1 above). A review of the revised precautionary instruments access criteria would ensure that the Commission, in liaison with the ECB, and the ESM, are able to assess eligibility on the basis of the revised fiscal rules. In absence of such a review, the eligibility criteria would be based on a different framework than the one agreed by the EU Member States in the context of the EU's Economic Governance Reform, once the revised Treaty enters into force. This could lead to a situation in which a prospective PCCL beneficiary that complies with the prevailing fiscal rules and other eligibility criteria, would be precluded from access. Such a result would be at odds with one of the objectives of the PCCL, namely, to signal to the markets the soundness of policies followed by the Member.

The eligibility criteria for precautionary instruments that are specified in the Annex III to the revised ESM Treaty can be amended by the Board of Governors by mutual agreement followed by the notification to the Depositary by all Members that their applicable national procedures have been completed. ESM Members could therefore consider aligning the eligibility conditions of the revised

¹³ See [Economic governance review: Council and Parliament strike deal on reform of fiscal rules - Consilium \(europa.eu\)](https://www.consilium.europa.eu/en/press/press-releases/2024/04/16/)

¹⁴ It is noteworthy that a minimum 0.5% net expenditure reduction benchmark will apply for those member states above 3% deficit.

precautionary instruments with the new Economic Governance Framework, following ratification of the revised ESM Treaty.

Under the current ESM precautionary instrument guidelines, changes to reflect the reformed Stability and Growth Pact (SGP) are not needed. Access to precautionary instruments is currently subject to respecting the commitments of the SGP, as confirmed by the European Council, and a sustainable general government debt. As such, the current guideline may coherently reflect the fiscal standards recently agreed upon within the fiscal rules, and how they are implemented within the SGP. Under the existing guideline, an ESM Member subject to an excessive deficit procedure (EDP) may remain eligible for the PCCL provided that provided it fully abides by the Council decisions and recommendations aimed at ensuring a smooth and accelerated correction of its excessive deficit. Through the reform of the fiscal rules, the activation of an EDP will require an update of the fiscal plans. This corrective Medium Term Fiscal Structural Plans will establish a revised net primary expenditure path that would ensure the minimum structural adjustment efforts required under EDP. As long as Member States respect this expenditure path, they would thus be assessed as having taken effective action in response to the Council recommendation. As such, the transparency of fulfilling the eligibility criteria for precautionary assistance will be enhanced under the new fiscal framework.

2.1.4 Lessons from the Pandemic Crisis Support

In December 2022, the Pandemic Crisis Support (PCS) credit line expired, marking the end of the ESM's contribution to the comprehensive European Covid-19 response. As an important milestone in the history of the ESM and its precautionary instruments, the PCS and the wider pandemic experience provide an opportunity to draw lessons for future crises.

Description and Analysis of the PCS

The PCS was swiftly agreed by Members as part of the common European response to the Covid-19 emergency. On 9 April 2020, the Eurogroup agreed on a comprehensive economic policy response to the crisis by creating safety nets to support workers, businesses, and sovereigns.¹⁵ The general escape clause of the EU fiscal framework was also activated. For the sovereigns, an agreement was made for the ESM to create a temporary credit line, the PCS. Its specific features were agreed by the Eurogroup on 23 April 2020 and approved by the ESM Board of Governors on 15 May 2020.

The PCS credit line was designed based on the framework of the ECCL instrument. Overall, €240 billion of the ESM's lending capacity was made available, offering each Member access to a credit line equivalent to 2% of their GDP. Loans under these credit lines would have had a maximum maturity of 10 years. To fund the PCS, a new funding silo was created in the ESM to isolate Members from the costs of previous programmes. A Social Bond Framework was also developed in order to issue 'Social Bonds' for the PCS. Considering the exceptional nature of the Covid-19 shock, the pricing modalities were more favourable compared with the other ESM precautionary instruments. Finally, the only condition to access the PCS was to use the borrowed funds to finance domestic direct and indirect healthcare expenditures, as well as cure and prevention related costs due to the Covid-19 crisis. All

¹⁵ Eurogroup (9 April 2020), [Report on the comprehensive economic policy response to the Covid-19 pandemic](#).

Members were confirmed as eligible for the PCS on 11 May 2020, based on the preliminary assessments by the Commission, in liaison with the ECB, and in collaboration with the ESM.

Given the common and unprecedented nature of the Covid-19 shock, the PCS was structured to provide both full ex-ante and ex-post transparency to Members. This was achieved through up-front confirmation of qualification and undifferentiated access to ESM assistance which sought to reassure Members and the markets alike that liquidity support was available, if needed, and under what terms. Given the uncertainty related to the Covid-19 shock itself, the instrument was available until the end of 2022.

The swift creation of PCS contributed to the strong signal of support to reinforce the resilience of the euro area in a time of crisis. In light of the co-ordinated response from multiple institutions to address the pandemic, it is difficult to isolate the effects of the PCS alone. The credit line was made available during a period of very low interest rates and a highly accommodative ECB policy providing support to markets with quantitative easing measures. Still, market participants¹⁶, including credit rating agencies, have acknowledged the announcement effect of dedicated ESM support, along with the wider European safety nets elaborated during the pandemic, which contributed to preventing any sudden interruptions in cross-border financial flows¹⁷.

Understanding the PCS experience

The PCS was designed and operationalised within a short time during an unprecedented crisis. As a temporary arrangement, understanding which lessons to draw from the PCS experience may provide insights for the ESM precautionary instruments. In particular, it is worthwhile to underscore two key features of the PCS within the remit of ESM precautionary financial assistance framework. Together, these two features have demonstrated the flexibility of the ESM in shaping its instruments within the institution's mandate.

1. **Up-front qualification of Members and transparent financial terms prior to granting the PCS.** All Members were assessed to be eligible for the PCS at the onset of the instrument. Furthermore, the amount of funds and the terms through which financial assistance was made available via the PCS were published prior to granting the instrument, as opposed to after a request has been made under the standard ECCL framework.
2. **The adapted use-of-funds condition reflected the purpose of the PCS and respected the ESM Treaty requirement to set conditionality commensurate with the chosen instrument.** This condition ensured that any disbursed funds would be directed towards the consequences of the shock and received a positive assessment from the Council Legal Service, which concluded that the PCS conditionality would respect the provisions of the ESM Treaty, the ECJ judgement in the *Pringle* case, and the Treaty on the Functioning of the European Union.

The PCS experience marked a new chapter in the use of the ESM toolkit for crisis resolution. The following insights based on the ESM analysis, feedback by Members, and comparisons with the SURE instrument (see Table. 2) help understand why the instrument was not used and provide valuable lessons for future crisis resolution and prevention with the precautionary instruments:

¹⁶ See: April 2020 – Moody's – Credit Opinion: Update after creation of "Pandemic Crisis Support" credit line"

¹⁷ 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.](#)

Table 2.

Design features of the PCS and SURE instruments

		PCS	SURE
Size of Instruments	Size of Loan	2% of GDP ensured for all Members	No pre-allocated envelopes for each Member States
	Maturity	Maximum average of 10 years	15 years on average
	Envelope	€240 billion	€100 billion
Funding Strategy		Diversified Funding Strategy – Normally the ESM raises funds through a variety of instruments, whose proceeds are then pooled and disbursed to programme countries. A separate silo was created for the PCS to segregate costs of these loans from other ESM facilities	Back-to-Back – Bonds are issued, and the proceeds transferred directly to the beneficiary country on the same terms
Pricing		Upfront service fee – 25 bps Annual service fee – 0.5 bps Margin – 10 bps	Ad-hoc issuance fees
Eligibility		ESM Members only, using ECCL criteria	EU Member States whose actual and planned public expenditures had suddenly and severely increased due to national measures directly related to short-time work schemes due to the Covid-19 pandemic
Use of funds conditions		Limited to health-related expenditures	Limited to short-term unemployment support schemes and to some health-related measures
Surveillance		ESM Early Warning System and adapted European Commission Enhanced Surveillance	Implementation reports produced by both beneficiary Member State and the Commission every 6 months
Approval process		Decision by the ESM Board of Governors	Implementation decision granted by the Council of the European Union.
Objective		Support health expenditures	Support employment

Source: ESM and European Commission

- According to most ESM Members, the differences in uptake in the PCS and SURE can largely be explained by political stigma – an issue that needs to be further addressed despite significant steps to do so in the past.** Institutional stigma is a common challenge to the IMF and all regional financing arrangements. It is often associated with surveillance requirements of far-reaching reforms as well as the political and reputational costs of asking for external assistance and the associated approval process. For both the PCS and SURE, the limited conditionality and the reduced surveillance were unlikely sources of stigma. The ESM seems to be associated with past macroeconomic adjustment programmes, which prevented some Members from requesting the PCS. Efforts have been taken through the ESM reform process to address the stigma issue. This work should continue, including though a greater dialogue with key stakeholders.
- Providing a more structured framework for bundling several PCS requests together would have ensured an efficient process and address the “first-mover” stigma.** Some Members highlighted that they would only request the PCS as part of a larger group of countries. The Commission was able to account for this through a co-ordinated SURE request strategy and a

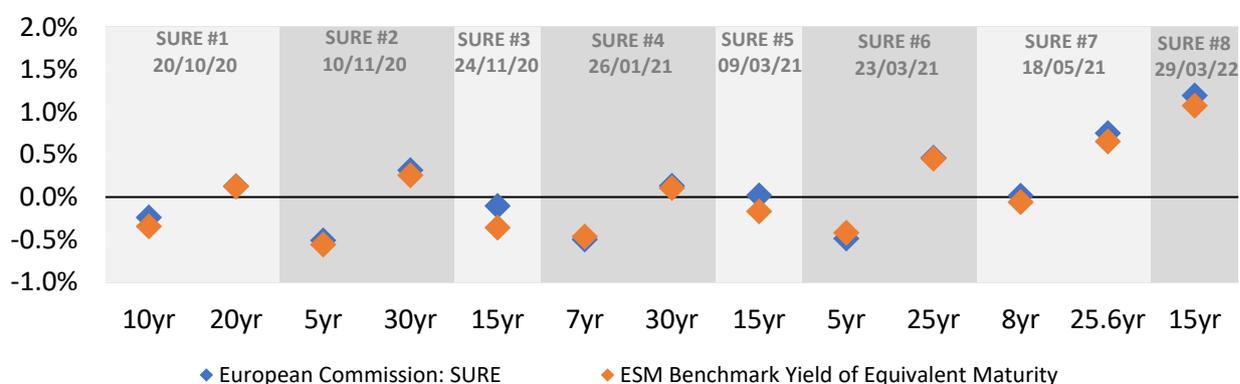
smooth internal approval procedure.¹⁸ Under the ESM framework, no procedure was foreseen to bundle requests, either formally or informally, and possibly coordinate their timing with the SURE approval process, which would have been warranted as the two instruments were announced simultaneously.

- **The reporting burden was comparable under both instruments while both processes added-up to the workload.** As a requirement established under Regulation (EU) No 472/2013 of the European Parliament and of the Council, monitoring of Members benefiting from the PCS would have taken place through the Enhanced Surveillance process. Conversely, in the case of SURE, implementation reports had to be produced to monitor the use of funds. To ensure comparability between the two instruments, the Commission decided to reduce the reporting requirement under enhanced surveillance for the PCS to only cover the use of the funds. Still, some Members highlighted that the PCS would have caused additional administrative burden. To ensure the precautionary instruments remain adapted to the nature of their purpose, and to further address concerns of stigma, ESM staff deems that there are merits in a dialogue on the way in which enhanced surveillance would be conducted for the PCCL and ECCL, in light of the different approaches which emerged through the PCS and SURE instruments. Yet, any follow-up action on enhanced surveillance would be in the Commission's remit.
- **As regards decision-making, the provision of financial assistance under SURE was decided by the EU Council, whereas granting of PCS support was in the remit of the Board of Governors.** SURE assistance required a qualified majority approval in the EU Council, while PCS assistance required a mutual agreement in the ESM BoG in addition to the completion of required national procedures in some Members.
- **The PCS and SURE were complementary and small differences in their financial terms most likely did not play a role in the uptake decisions.** The PCS fees and margins were reduced compared to the ECCL, while the additional fees of the SURE instrument were not significant. The longer maturity offered by the SURE instrument may have also offered a greater savings in aggregate over the cycle of the loans. These differences in maturity and funding structures (diversified funding vs. back-to-back) do not allow for a fair financial terms comparison without making larger assumptions. However, as shown in Figure 5, comparing the yields on bonds issued through the SURE scheme at time of issuance with the then-benchmark ESM yields of equivalent maturity does not indicate significant differences in market funding terms. The existence of the ECB's non-standard monetary policy measures supported sovereign market access, thus reducing the benefits of an ESM loan. Still, many ESM Members could have benefited from both the SURE and the PCS instruments as they served different purposes, whilst benefitting from interest savings in both cases (see Annex A).

¹⁸ All SURE recipients, excluding Estonia and Ireland, requested the instrument on either 6 or 7 August 2020. Following these requests, and the European Council decisions to grant the instruments, the subsequent steps in the SURE procedure were conducted bilaterally and internally. These steps were the completion and submission of the loan file by the EU Member States, the establishing of a loan agreement with the Commission, and finally a borrowing decision.

Figure 5.

Comparison of yields at issuance of SURE bond issuances with equivalent ESM benchmark yields



Source: ESM, European Commission

Having considered the differing uptake between the PCS and SURE instrument, a follow-up workstream could be initiated to address the stigma concern related to the ESM role. Important elements of this work would include possible refinements of the ESM precautionary toolkit and processes, which are analysed in the following section.

2.1.5 Possible refinements of the ESM precautionary instruments

The emerging challenges for the euro area as well as lessons learned from the design of PCS provide a starting point for considering refinements to precautionary instruments. Vulnerabilities that could manifest from risks such as climate change, geopolitics, and geoeconomic fragmentation pose a particularly uncertain outlook for the euro area. At the same time, the stigma associated with ESM support hampers access to its instruments by its Members even in case of severe crises. Against this backdrop, the ability of the ESM toolkit to tailor responses to a multitude of contexts remains a vital safeguard. To ensure these instruments remain effective, their design could be refined in two areas:

- By making good use of the confidential consultation procedure, including as a platform for group requests.
- By analysing the merits of designing a new precautionary instrument.

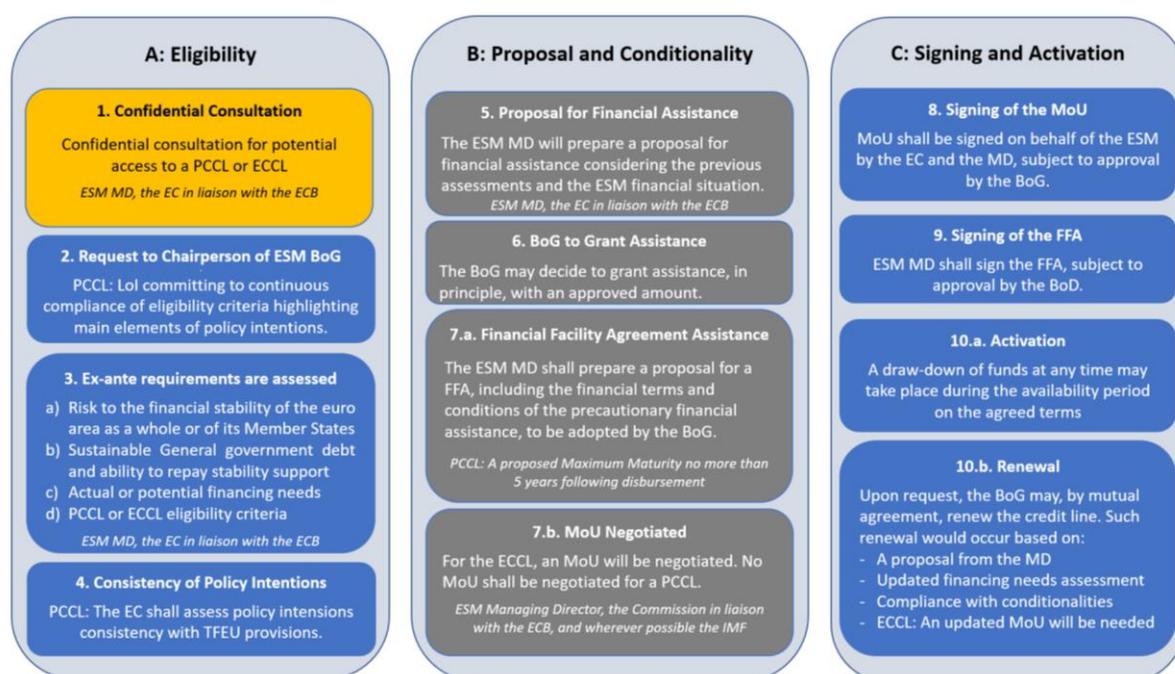
Use of confidential consultations to improve the effectiveness of the ESM precautionary instruments

The process through which precautionary assistance is requested and granted is of crucial importance for its effectiveness. It ensures that the formal requirements of the ESM Treaty are respected. It can also provide prospective beneficiary ESM Members with more concrete information on potential ESM assistance before submitting an official request. The procedure to request the precautionary instruments under the revised Treaty can be summarised in Figure 6.

Making use of the confidential consultations to facilitate group requests would strengthen the PCCL and ECCL. The revised guideline for precautionary instruments allows Members who are interested in requesting financial assistance to conduct a confidential consultation on their potential access to a PCCL or an ECCL.¹⁹ This procedure was designed to offer transparency and clarity regarding the assessments by the Commission, in liaison with the ECB, and the ESM, concerning eligibility under the credit line, debt sustainability, and other required assessments, as well as possible measures to be included in the Memorandum of Understanding before a Member decides to request ESM support. Insights from the PCS experience underscore the value of providing early sufficient clarity on how such assistance would look like. Going forward, the already foreseen confidential consultations procedure could serve as a platform to enable group requests. As highlighted by the PCS experience, this would entail grouping several requests in one process to facilitate a swifter response to potential crises while overcoming the ‘first-mover’ problem. The confidential consultations could be used as a co-ordination phase while the official steps to grant precautionary assistance would remain as foreseen in the ESM Treaty, ensuring that a request for assistance from a Member is assessed on its own merit.

Under the existing precautionary instruments guideline, a confidential consultation is not formally articulated, however an informal consultation is possible. Whilst equally non-binding, and subsequently subject to the formal procedures, many of the elements previously discussed could feasibly be conducted.

Figure 6.
Summary of the request and granting procedure for the revised ESM precautionary instruments



Source: ESM

Note: For brevity, the full stipulations of the guidelines are not shown in this summary. Each step requires the conditions in previous steps to be fulfilled. Numbering is not aligned with specific articles in the revised guidelines.

¹⁹ To be conducted by the ESM Managing Director, European Commission in liaison with the ECB

The ESM precautionary instruments in their current form provide a signalling effect by certifying a Member's sound economic state, although they remain primarily an insurance instrument. ESM Members eligible for precautionary support - under the existing or revised framework - fulfil several criteria underscoring their economically sound state, which entails a confidence signal. In addition, the possible activation of the credit line or drawing through primary market purchases can serve as a form of temporary insurance against concerns of severe funding difficulties. This improves market confidence and could in turn provide greater breathing space for a Member to take the appropriate measures to offset emerging risks. The favourable terms of ESM support provide an easier pathway to return to pre-crisis fiscal stances in the long term. Still, the precautionary instruments were primarily not meant to be drawn. In fact, the current Treaty describes the instruments' purpose to *"support maintaining continuous access to market financing by reinforcing the credibility of macroeconomic performance while ensuring an adequate safety-net"*. Furthermore, once a credit line is activated, a mandatory evaluation of the suitability of the precautionary instruments is needed under the existing guideline, to determine whether more substantial or alternative assistance is needed.²⁰ Still, once granted, Members can draw from the credit line at any time during the availability period.

Activating the credit line to fund a specific purpose, support confidence and protect against distress, instead of using it as blanket insurance against market access loss, might send the wrong signal. Drawing funds is already possible under the existing and revised ESM Treaty and instrument guidelines. Yet, the instruments are primarily dedicated to insuring against market loss. If needed, they could be tailored to fund specific expenditures, as was foreseen under the PCS. Even so, maintaining the ESM instruments as a 'one-stop shop' and requesting a disbursement from a perceived insurance-like contract early during a crisis could provide the wrong signal that the crisis effects have materialised even if the funds were used for preventive expenditure identified in advance. To safeguard against such risks, the ESM precautionary framework could further evolve by adapting existing instruments or creating a new one, which would be warranted under both existing and revised Treaties.

While the existing precautionary credit lines can protect the ESM Members from external shocks, their refinement through a dedicated credit line could be explored to strengthen their signalling power. Options are available to ensure the precautionary instruments remain adequate to cater to emerging risks. The precautionary instruments could remain a 'one-stop shop' for preventive assistance, and if needed, they could be tailored to fund specific expenditures. Alternatively, adding a new credit line could be analysed to address the economic consequences of external shocks, notably climate, geopolitical and fragmentation risks with a financial stability impact. Such a new instrument would send a stronger signal of confidence concerning economic policies and eliminate the risk that drawing on the credit line would be perceived as a sign of weakness. In addition, creating a new instrument would associate the ESM assistance with emerging challenges, and therefore reduce prevailing concerns of stigma. It would require a tailored framework, including specified maximum available amounts, maturities, pricing, and other financial terms as well as the necessary safeguards. While respecting the ESM Treaty provisions, which require in Article 3 that stability support is *"subject to strict conditionality, appropriate to the financial assistance instrument chosen"*, its use should be subject to eligibility criteria and should preserve incentives for sound budgetary policy. This could

²⁰ This requirement will no longer exist under the revised precautionary instruments guideline.

require, amongst others, beneficiary countries to respect the commitments under the reformed SGP as assessed by the European Commission. Members subject to either an excessive deficit or imbalance procedures could access the instrument, provided they take effective action in response to the Council recommendations made to correct the imbalances. Furthermore, certain design elements of the PCS could be considered, such as pre-established uses of funds to address a range of emerging challenges. Formally, it could be established by introducing a new instrument as foreseen under Article 19 of the existing and revised ESM Treaties.

Key findings

The precautionary instruments remain key for the ESM's crisis prevention role, which is likely to be increasingly relevant in the context of a shock-prone regional and global environment. Crisis prevention is less costly than crisis resolution as it allows providing stability support early to limit negative spillovers and prevent contagion. Yet, the experience during the Covid-19 pandemic, confirmed by ESM Members' feedback shows that ESM Pandemic Crisis Support was not accessed due to political stigma, prevailing low borrowing costs, and instruments provided by European institutions, which supported sovereign market access during that period.

ESM precautionary instruments could become more effective after addressing the issue of political stigma, which could be achieved by enhancing the role of confidential consultations and enabling group requests for assistance.

Moreover, after the agreement on the reform of the Economic Governance Framework, there is a need to analyse its impact on the revised ESM precautionary instruments eligibility criteria. An alignment would be warranted to maintain consistency of the revised precautionary instruments with the European fiscal rules.

Finally, the ESM precautionary instruments, which primarily function as insurance, could be used and adapted to address emerging risks. The existing and revised Treaties also include the possibility to create a dedicated instrument, which would facilitate lending for specific purposes during a shock. This would preserve financial stability while avoiding further increases in Members' liabilities and costs. It would also address the political stigma associated with ESM support through improved signalling and a greater preventive role.

2.3 ESM market support instruments

The Primary Market Support Facility (PMSF) and the Secondary Market Support Facility (SMSF) have been part of the ESM toolkit since the beginning. Although neither instrument has been used thus far, Members decided that both facilities should remain largely unchanged as part of the ESM reform. While the main objective of the PMSF is to allow Members to maintain or restore market access, the SMSF aims to support the good functioning of the government debt markets of Members when the lack of market liquidity threatens financial stability (see table 3 below for an overview of their main characteristics). For both instruments, important interactions with ECB purchase programmes exist.

2.3.1 Primary Market Support Facility

The PMSF can serve as a means of disbursement in the context of a macroeconomic adjustment programme or precautionary financial assistance. The ESM is the only euro area institution that can intervene in the primary market to finance a country's debt. Once a country enters a programme, it can in turn request the draw-down of funds as a primary market intervention via the PMSF. Through the PMSF, the ESM can act as a backstop in primary transactions. In this way, the PMSF can support Members in stabilising or regaining market access.

The link between the PMSF and OMT enforces stability. During the financial crisis, the PMSF was not used. Nevertheless, its importance was enhanced during the crisis when the ECB decided to make OMT conditional on strict and effective conditionality attached to an appropriate ESM programme, provided that such a programme includes the possibility for the assisted country to use the PMSF. With this decision, the mere possibility to access the PMSF already makes an important contribution to financial stability as it shapes market expectations.

For the ECB, the PMSF is important in the context of OMT. It reassures the ECB that its government bond purchases do not undermine incentives for reforms at national level, it protects the ECB against balance sheet risks, and it shields it against criticism of fiscal dominance, because the prior activation of an ESM programme does not depend on the decision of the beneficiary Member State, but on a unanimous decision by all Members to grant conditional financing.

Also outside the OMT context, the PMSF remains a powerful tool by providing support for market access and programme financing simultaneously. It can contain market turbulence by directly reducing the risk of a beneficiary Member States experiencing a failed transaction, by ensuring additional demand in government bond markets (thus lowering the interest rate at issuance), and by contributing indirectly to greater liquidity in the secondary market.

2.3.2 Secondary Market Support Facility

The SMSF is accessible either in the context of an ESM macroeconomic adjustment programme or as a stand-alone instrument if a Member's economic and financial situation remains sound. Unlike the PMSF, it does not finance the beneficiary Member State directly. Instead, the SMSF was created to ensure liquidity in sovereign debt markets and potentially stabilise market prices in case of bond market tensions. Using the SMSF is intended to encourage private investors to further participate in the financing of Members.

Eligibility is determined by compliance with policy conditionality under a loan facility or by meeting a set of criteria establishing that the economy remains sound. Moreover, the SMSF is subject to an ECB assessment recognising "exceptional financial market circumstances". Once these criteria are met, the ESM can use the SMSF to intervene in the secondary market to support market functioning.

The objectives of the SMSF and the ECB’s asset purchases are different, yet the existence of the latter seems to have reduced the need to access the former in the past. A Member can be granted access to the SMSF when a lack of market liquidity threatens financial stability, entails a risk of pushing sovereign interest rates towards unsustainable levels, and creates refinancing problems for the banking system concerned. ECB asset purchases, meanwhile, follow the ECB’s price stability objectives and cannot support a single euro area sovereign upon request. The ECB first deployed its Securities Markets Programme in 2010 to address dysfunctions in the monetary policy transmission mechanism during the financial crisis. This was followed by the introduction of OMT in 2012 and the Asset Purchase Programme (APP), which was initiated in mid-2014. Overall, these large-scale bond market intervention programmes effectively reduced market disturbances and thus limited the need for individual Members to request ESM secondary market support.

ECB interventions continue to support secondary markets. To date, OMT and TPI were not used to make market purchases, while the APP and the PEPP have been used while the latter still generates reinvestments. Unlike OMT, the TPI does not require an ESM programme with conditionality, and the ECB can use it to intervene in long maturities. The TPI might thus reduce the potential need for SMSF purchases in future precautionary programmes under the circumstances where both instruments could be deployed.

The ECB has some important advantages when it comes to secondary market purchases. In line with its mandate, the ECB can intervene with full independence and in potentially unlimited amounts as the ECB does not need to finance its purchases via issuances to the market.²¹ Moreover, it benefits from a credible track record of interventions. As recent ESM research shows, past ECB interventions have created *pre-announcement expectations* that contain the divergence of spreads even before monetary policy decisions are announced (Blotevogel et al. 2022; see also Blanchard 2022; Lorenzoni and Werning 2019). Once policies are announced, moreover, the compression of spreads for countries with lower credit ratings is very large. As the authors observe, this *announcement effect* is even stronger than the actual *implementation effect*.

Considering the differences between ECB and ESM purchase programmes, the most likely scenario for a recourse to the SMSF is the case of “bond market tensions without implications for monetary policy transmission”. In this hypothetical case, the ECB would not conduct secondary market purchases and the SMSF becomes an attractive option for Members. Initiating the SMSF would impact the lending capacity of the ESM.

Overall, market support instruments diversify the channels through which the ESM can act to deliver on its mandate and seem to complement other euro area policy responses. The existence of the ECB purchase programmes over the last decade reduced the need for the SMSF. Still, non-standard monetary policy measures do not substitute for the ESM instruments that Members can request in case a lack of market liquidity threatens financial stability.

²¹ Flexibility is restricted by the ESCB’s decision to adhere to (i) a purchase limit of 33% of a particular issue of bonds of a Member State, (ii) a purchase limit of 33% of the outstanding securities of a Member State, and (iii) a purchase limit in line with the ECB’s capital key. Moreover, bonds of public authorities may only be purchased if the issuer has a minimum credit quality assessment that provides access to the bond markets. This is intended to protect the ECB’s balance sheet, prevent monetary financing, and avoid undesirable fiscal redistribution effects.

Table 3.
ESM market support instruments – main characteristics

	PMSF	SMSF
Action	Primary market bond purchases	Secondary market bond purchases
Creditor status¹	Pari-passu	Pari-passu
Size of intervention²	No upfront cap Max. 50% of issuance	No upfront cap
Price	Approximation of market price: (i) auction: weighted average price; (ii) syndicate transactions: offer price	Market price
Maturity³	No indication	No indication
Availability period⁴	Availability period follows the availability period of the ESM facility it is attached to (loan or precautionary instrument).	No timeframe
Eligibility	Signing of MoU/LoI and FFA which includes a PMSF draw down modality	Compliance with existing adjustment programme or sound economic and financial situation
Conditionality	Compliance with terms of MoU/LoI	Compliance with terms of MoU/LoI

Notes:

1. Any ESM shortfall will be converted into a loan, on which the ESM has preferred creditor status.
2. Subject to the financing the ESM can mobilise.
3. The maturity would follow the maximum maturity of the assistance instrument.
4. Bonds can be held to maturity.

Key findings

The ESM's Primary Market Support Facility and the Secondary Market Support Facility remain important as they have a strong impact on market expectations, which derives partly from their close links to ECB purchase programmes.

2.4 ESM financial assistance for the recapitalisation of financial institutions

The IRI was introduced at the ESM's inception and was used to support the Spanish banking sector in 2012-2013. The financial assistance programmes to both Greece and Cyprus also included funds earmarked for bank recapitalisation.

The IRI provides funding assistance to ESM Members experiencing a financial crisis for which the root causes stems from the financial sector rather than from fiscal or structural policies. To be eligible, a beneficiary Member State should demonstrate that its financial institutions are unable to address their capital shortfalls via private sector solutions and it needs to recapitalise the concerned institutions while avoiding adverse effects for its own financial stability and fiscal sustainability. The institutions to be recapitalised should be of systemic relevance or pose a serious threat to the financial stability of the euro area or its member states. Conditionality through the IRI is set such that the concerned Member

should maintain its ability to reimburse the loan and improve its financial restructuring or resolution frameworks through reforms to financial supervision, corporate governance, and domestic law.

The core functioning of the IRI is unchanged in the revised ESM Treaty. The IRI is intrinsically linked to the regulatory and supervisory environment, which has evolved significantly and moved to the supranational level since the instrument was created and used. The final assessment of potential implications for IRI of the latest proposal by the Commission for a new bank crisis management framework will merit a separate analysis once the proposal is approved.²² Under the current proposal, recourse to precautionary recapitalisation is possible but under stricter conditions and would require some adaptations to the IRI. Finally, understanding how emerging financial risks due to climate change or increased volatility in the markets may impact both financial and non-financial institutions may provide insights for the role to be played by the IRI going forward.

2.4.1 The IRI instrument in an evolving regulatory and institutional landscape

The IRI was designed at the ESM inception and used once, during the Spanish banking sector crisis in 2012-13, before the introduction of banking union. Other EFSF/ESM programmes, namely those for Cyprus and Greece, also included financial assistance for bank recapitalisation. However, these were part of larger macroeconomic adjustment programmes, unlike in the case of the financial assistance to Spain, which was provided for the sole purpose of bank recapitalisation.

The single use of the IRI proved critical in complementing the national policy response and private sector solutions to a capital shortfall. The ESM committed up to €100 billion in assistance to Spain, of which €41.3 billion was used. Unlike other country cases during the euro area crisis, the IMF did not provide financing to Spain and only acted as an advisor.

The IRI allowed Spain to clean and recapitalise its banking sector, reforming ownership structures and improving risk management practices (Tumpel-Gugerell 2017). Spain exited the programme in December 2013 and, as a sign of strong recovery, proceeded to start voluntarily repaying ESM loans earlier than required.

Another unique feature of the IRI use case was the fact that the bank recapitalisation was done “in kind” using ESM notes, without the need for the ESM to access the markets. This enabled the provision of financial support to be implemented rather quickly. In addition, limiting the conditionality associated with financial assistance to financial sector reforms reduced the political stigma. Spanish macroeconomic reform commitments were applied through the European Semester without an explicit link to the IRI financial assistance.

Today, the IRI exists within the framework of banking union created to address the sovereign-bank nexus. As part of this instrument’s review, it is therefore important to understand the evolution of the supervisory, resolution and regulatory framework since the instrument was established and used, and whether the IRI remains relevant for the type of shocks and risks the financial sector is likely to face going forward.

The advancement in financial regulation and the deepening in supranational oversight in the euro area since the sovereign debt crisis have decreased the likelihood of systemic risks stemming from

²² Banking Union: Commission proposes reform of bank crisis management and deposit insurance framework https://ec.europa.eu/commission/presscorner/detail/en/ip_23_2250

the financial sector. Solvency, macroprudential and supervisory frameworks have evolved since the IRI was introduced, requiring financial institutions to operate with stronger risk management safeguards while being aware of the limits of public intervention in the event of distress. A vast number of corrective and monitoring measures are now in place both at the national or European level due to the new institutional landscape.²³ As a result, banks are better supervised and capitalised than before. The new resolution framework has introduced a stronger role of bail-in, beyond the “burden sharing” concept applied before the reform; moreover, the introduction of the SRM provides for an industry-funded resolution mechanism thus limiting and ideally ruling-out Member States’ role in bank rescues.

In this context, the definition and implementation of conditionality associated with any future use of IRI would have to take into account extensive supervisory convergence in the euro area, fostered by the set-up of the Single Supervisory Mechanism (SSM). Any conditionality associated with an IRI support would also need to be agreed in cooperation with the SSM considering its practice and independence.

Nevertheless, the IRI remains relevant given its potentially versatile role within the euro area financial system. In particular, the review has identified the following possible use-cases for the IRI going forward:

- **The IRI can be effective in addressing systemic issues affecting several financial institutions, possibly across multiple Members, at the same time.** The current resolution framework focuses on individual institutions, while the IRI remains an important tool to support Members in addressing system-wide vulnerabilities that are affecting financial institutions across the euro area. In addition, the use of IRI could also be envisaged following resolution of a bank by the SRF, in the context of government financial stabilisation tools.²⁴ Although unlikely, in such case this could be done through public equity support, under the conditions set in Article 57 of the BRRD. Though permissible under the legal framework, such use of IRI would require support by ESM shareholders and would also have to be foreseen in the resolution scheme.
- **In the context of the banking union, the IRI can complement the existence of the SRF and the common backstop²⁵.** Under the current EU legal framework, the IRI could be used at an early stage of financial sector distress as a form of precautionary recapitalisation, although this is subject to the final outcome of the CMDI framework reform which may limit the scope for this use²⁶. As laid out by the Bank Recovery and Resolution Recovery Directive (BRRD), a precautionary

²³ As an illustration, under the Spanish ESM programme the national government hired Oliver Wyman for an ad-hoc comprehensive stress test. Nowadays, the EBA conducts bi-annual stress tests complemented with the annual SREP exercises by the SSM, the in-house stress test by NCBs and the ECB’s bi-annual macroprudential stress test.

²⁴ The basis for government financial stabilisation tools (GFSTs) is Article 37(10) BRRD, pursuant to which "in the very extraordinary situation of a systemic crisis" resolution authorities may seek funding from alternative financing sources through the use of GFSTs" as provided for in Articles 56-58 when the additional conditions set out in Article 37(10) and 56(4) are met (there are: (1) 8% bail-in has been applied, (2) approval under the State Aid framework, and (3) last resort. The transposition of Articles 56-58 into national law is at the discretion of Member States. GFSTs are not referred to in the SRM Regulation. Thus, their use is not a power conferred upon the SRB and the SRF is not involved. In this respect, attention should also be given to Article 6(6) SRMR, according to which the Council, the Commission and the SRB may not adopt decisions or take actions forcing a Member State to provide public financial support.

²⁵ The SRM will benefit from the ESM backstop in the event of fund depletion. The total SRF firepower will amount to 1% of covered deposits by participating banks, for a rough €70bn which could be doubled were the backstop to be activated.

²⁶ The current CMDI proposal restricts access to precautionary recapitalisation. Institutions must be deemed solvent by the competent authority - with no breaches of capital requirements (existing breaches, or breaches foreseen over the next 12

recapitalisation entails provision of extraordinary public financial support (Article 32.4 of the BRRD). This could entail an injection of own funds, at prices and on terms that do not confer an advantage upon the institution, into a solvent bank by the state when this is necessary to preserve financial stability and it does not trigger the resolution of the bank. Eligibility for precautionary recapitalisation is specified in legislation and is subject to supervisory scrutiny. The IRI amounts that are approved by the ESM also constitute a quantitative limitation on the amount of ESM funds that may be used to recapitalise a bank. The recapitalisation envelope is limited to injections needed to address a capital shortfall under the adverse scenario of the relevant stress test. Precautionary recapitalisation remains an exceptional measure, conditional on final approval under the EU state aid framework. As per the burden sharing principle, a state can only intervene after subordinated bonds have been converted into equity²⁷. Conditions for access to precautionary recapitalisations have been diligently enforced by European authorities as demonstrated by the cases of precautionary recapitalisation under the BRRD so far. The final outcome of the legislative discussions on the CMDI proposal is needed before discussing in more depth the implications for the use of IRI in the context of precautionary recapitalisations.

- **The IRI should also be considered a relevant and effective tool for addressing emerging risks to financial stability due to climate change, as well as potentially for tackling vulnerabilities in non-bank financial institutions.** The following pages provide further analysis on these possible IRI use-cases.

The IRI in the context of emerging risks posed by climate change

Risks emerging from climate change – be it physical risk or transition risk – may have significant implications for the financial sector²⁸. Climate change may represent a major source of systemic risk for the financial system. Compared to other risks to financial stability, climate-related risks – especially catastrophic events - are subject to substantial uncertainty in terms of frequency and severity, longer time horizons, and their capacity to affect many jurisdictions and sectors simultaneously, thus amplifying the potential impact.

Physical risk is of relevance for credit institutions and insurance companies. According to the ECB²⁹, physical risk could overall impact up to 30% of banks' corporate credit risk exposures in the euro area; moreover, these exposures appear to be more relevant for weakly capitalised and/or less profitable banks, while also being highly concentrated in a small number of institutions³⁰. The two main hazards relate to water stress (including floods) and heat stress (including wildfires)³¹. Another implication of

months). However, this could force a competent authority to conclude that an entity is not solvent based on mere technical or foreseeably temporary breaches of capital requirements. Also, the CMDI proposal discourages recapitalisation through CET1 instruments, and even when such a CET1 recapitalisation is done, it is only limited to 2% of the total risk exposure amount. Last, the CMDI proposal requires an exit strategy which, if not complied with, automatically leads to a declaration of failing or likely to fail.

²⁷ Prior to the introduction of the BRRD, burden sharing was present to some extent, but it was conducted in a non-systematic fashion. In Spain and Ireland, subordinated debt was converted. In Greece, both subordinated and senior debt were voluntarily converted into equity at more favourable terms than a mandatory conversion.

²⁸ Most of the statistical evidence upon which this subsection relies comes from the comprehensive work of the SSM and the ECB/ESRB joint initiative on climate change linkages with banking soundness and financial sector stability.

²⁹ [ECB \(2021\): ECB economy-wide climate stress test. Occasional paper, No. 281, September 2021.](#)

³⁰ [According to the ECB, 70% of bank exposure to firms subject to high or increasing physical risks is concentrated in 25 banks.](#)

³¹ By way of illustration, among EWS-monitored countries, Cyprus and Ireland are mildly exposed to floods while Spain, Portugal and Greece are heavily liable to fires, droughts, and water stress, with more than 50% of firms being subject to at least one of these risks. This translates into considerable loan exposure by banks: In the case of Spain, roughly €300bn worth of exposures are to NFCs located in areas of high or increasing physical risk; for the euro area aggregate the figure amounts to €1.2tn.

physical risk is that disasters also impair the value of physical assets that serve as collateral to bank lending. The insurance sector is also directly exposed and particularly vulnerable to the impact of climate change. Higher, more frequent, and increasingly correlated loss events will lead to higher payouts. Consequently, this leads to higher premia in the future and general concerns regarding the insurability of events. One consequence of this insurance protection gap is that a large share of the burden has to be borne by the government, thus increasing the fiscal burden and potential concerns of debt sustainability.³² Furthermore, via the pricing channel, extreme events may spill over to other market segments if insurers are forced to a significant sell-off of their assets to honour the claims.

Transition risk is also a source of vulnerabilities.³³ For financial institutions this risk materialises on the asset side, meaning that they could incur losses on their exposures to firms with a high and persistent carbon footprint. Recent research by the ECB and the European Systemic Risk Board (ESRB) signals that roughly 40% of bank loans from systemic institutions in the euro area are exposed to high transition risk (claims on high or very high-emitting firms), with moderate heterogeneity across countries³⁴. Insurers' investment in high-emitting industries is 10% on average but varies significantly across countries.

Climate-related litigation against financial institutions shows emerging trends. According to a report by the Network for Greening the Financial System (NGFS), there are three potential grounds on which financial institutions may be sued in the future: (a) greenwashing, (b) breaches of directors' duties, and (c) corporate due diligence laws³⁵. There appears to be no agreed supervisory framework on climate-related litigation risk at the moment. Nevertheless, these trends could ultimately result in losses for financial institutions from litigation itself, or constraints in pursuing business ultimately affecting profitability.

The IRI could be used to tackle the impact of climate change on financial institutions to the extent to which the financial stability risk from climate change propagates itself through these entities. The IRI is conceived to address cases "in which the roots of a crisis situation are primarily located in the financial sector" (Article 2.2 of the IRI Guideline). Hence, any decision on the appropriateness of using IRI would depend on whether the financial sector is most impacted. Furthermore, as in the case of use of any ESM instrument, resorting to IRI would need to be judged as indispensable for safeguarding the financial stability of the euro area and its member states in line with Article 3 of the ESM Treaty and the IRI Guideline.

Non-bank financial institutions as sources of risk

Other types of risks that deserve further reflection are those related to the non-bank financial institutions (NBFIs). In recent years, central banks and macroprudential authorities have highlighted the increasing importance of NBFIs as potential sources or amplifiers of systemic risk. While the majority of NBFIs may still be small compared to the banking sector, the sector as a whole has grown substantially over the last years and has almost tripled in size since 2007. Total assets of EU investment funds and other financial institutions (OFIs) reached a level of €41.5 trillion in 2022 and their share of credit to non-financial corporations (NFCs) doubled to 20 percent³⁶. EU insurers and pension funds represent another €8.9 trillion and €2.7 trillion, respectively. Total assets of NBFIs in the euro area

³² Cf. [ESM blog](#) on European risk sharing scheme for natural catastrophes.

³³ Transition risks refer to the financial impacts from the adjustment towards a lower-carbon economy.

³⁴ Cf. [ECB \(2021\): ECB economy-wide climate stress test, occasional paper No 281, September 2021](#).

³⁵ Network for Greening the Financial System: Climate-related litigation: recent trends and developments. September 2023, available here: [ngfs_report-on-climate-related-litigation-recent-trends-and-developments.pdf](#)

³⁶ [European Systemic Risk Board: EU Non-Bank Financial Intermediation Risk Monitor, No. 8, June 2023](#)

account for slightly more than 50% of total financial system assets (or more than 400% of the euro area GDP). High interconnectedness between the financial sector participants, banks, and non-banks, contributes to systemic risk and highlights the need for a holistic perspective. Interconnectedness in normal times contributes to the efficiency of the market, but it can become a risk amplifier in conditions of stress as it may propagate more easily across the system.

Systemic risk in the context of NBFIs can be assessed from two different angles – entity- or activity-based. The former regards the distress or failure of an institution as a necessary condition for emergence of systemic risk. Distress at the level of an individual institution may propagate through transferring direct or indirect losses to the rest of the financial system. The latter view focuses on the concern of common behaviour or exposures leading to considerable knock-on effects. The failure or distress of the institution(s) is not a necessary condition although – to qualify for IRI – the beneficiary institution would have to demonstrate that it lacks alternatives to recapitalise, either in the private market or through government assistance. In this case, the systemic concern may stem from the simultaneous actions of several market players. The “dash for cash” at the beginning of the Covid-19 crisis or the gilt crisis in the UK in autumn 2022 are phenomena of liquidity crises that fall into this category, in which NBFIs were important protagonists. For NBFIs, the activity-based angle is the more prevalent concern, even though systemic risk following the distress of an insurer cannot be ruled out, as the case of AIG during the Great Financial Crisis highlights.

The possible use of the IRI in case of financial stability risks stemming from NBFIs could be considered, although the rationale may somewhat deviate from the banking case, given the distinctive way in which systemic risk could propagate from NBFIs. The IRI is not explicitly limited to banks and can be applied, in principle, to NBFIs. While Article 2 of the IRI Guideline restricts the use of the instrument to “support financial institutions (...) and financial stability”, it does not circumscribe this to banks only as there is no definition of “financial institutions” in the ESM Treaty or the Guideline. At the same time, the Guideline refers to European supervisory authorities – EBA, ESMA, and EIOPA³⁷. Hence, a reasonable assumption is that “financial institutions” is a concept that could be interpreted more broadly than “credit institutions”, i.e. including entities other than credit institutions under the remit of the national supervisory authority, as well as institutions under the remit of such bodies. In either case, the entity to be recapitalised would have to satisfy the requirement of systemic relevance laid out in the Guideline. It would also have to be an entity that is subject to stress tests, as this is a key condition in the granting of support (Article 4.2, of the IRI Guideline).

Given that there appears to be some flexibility in the Guideline, the ESM further analysed the application of IRI to investment firms, pension funds and insurance companies. These entities are under the remit of ESMA and EIOPA respectively and would be the main NBFIs that could potentially meet the systemic test outlined above. The regulatory framework for recapitalising investment firms and insurance companies is set out in Annex B. The recapitalisation regime for the larger investment firms (Class-1 and Class-2) is similar to that of banks, and the use of ESM funds would equally be subject to state aid rules. For insurance companies, a proposal for harmonisation (IRRD) of insurance companies’ resolution regimes does not include exemptions that would enable extraordinary public financial support if adopted as currently drafted, which appears to present a significant obstacle to ESM indirect recapitalisation of insurance companies.

³⁷ The European Securities and Markets Authority (ESMA) supervises credit rating agencies (CRAs), securitisation repositories (SRs) and trade repositories (TRs). The European Insurance and Occupational Pensions Authority (EIOPA) oversees insurance undertakings, reinsurance undertakings, institutions for occupational retirement provision and insurance intermediaries.

If the IRI were to be used for NBFIs, the ESM's assistance would still need to be in the form of a capital support tool, and not primarily provided for the purposes of supporting liquidity. Article 15 of the ESM Treaty defines IRI as a recapitalisation tool. In previous cases, capital support was provided to banks which then enabled beneficiary institutions to increase their liquidity, but the character of the ESM's assistance would need to take the form of a capital tool. ESM support could not, for example, be used to primarily fund a liquidity line to an NBFI and/or in absence of any capital support element.

Finally, in addition to legal and technical considerations on the possible use of the IRI for NBFIs, there are also important political ones. NBFIs, including those potentially considered for support via the IRI, encompass a very diverse set of institutions in terms of their business model, risk appetite, and regulatory regime applied. To what extent it would be politically acceptable or desirable, including from the moral hazard point of view, to use public funds to support some of these entities, in particular those with high-risk high-profit business models, would depend on the particular context as well as national and EU-level policy preferences.

Key findings

The role of the IRI has been impacted by the evolving EU regulatory and supervisory landscape and development of banking union, which was not in place when the instrument was initially designed and used. Nevertheless, the IRI remains sufficiently versatile in the current institutional and regulatory context and potentially relevant in addressing new sources of risk.

In the context of banking union, the IRI can complement the existence of the SRF and the common backstop. The IRI can be effective in addressing systemic issues affecting simultaneously different financial institutions, possibly across multiple Members. Under the current EU legal framework, the IRI could also be used at an early stage of financial sector distress as a form of precautionary recapitalisation, although this is subject to the final outcome of the CMDI framework reform which may limit the scope for this use. Finally, the IRI could be considered as an effective tool for addressing emerging risks to financial stability due to climate change. The potential scope for addressing vulnerabilities in non-bank financial institutions appears to be limited yet it should not be dismissed given the increasing size of the sector and its interconnectedness with other segments of the financial system and the real economy.

2.5 The common backstop and ESM lending capacity

Upon ratification of the revised ESM Treaty, the ESM toolkit will include a new instrument, the Backstop Facility to the Single Resolution Fund (SRF). The new instrument introduces two novelties to the ESM toolkit. First, it will allow the ESM to finance an EU agency, and second, it will provide a revolving credit line with relatively short loan tenors.

As part of the ESM reform process in late 2019, the nominal cap of the backstop was agreed to be €68 billion, which at the time had been projected to be above the target level the SRF would reach by 2024. However, as of 31 December 2023, the SRF is fully funded and mutualised, and its size exceeds the nominal cap. An increase in the size of the SRF does not trigger an automatic increase of the nominal

cap or the maximum amount of the backstop. It is therefore proposed to revisit the issue of the size of the backstop after the entry into force of the revised ESM Treaty.

The introduction of the common backstop to the SRF remains of utmost importance for financial stability. As highlighted by the SRB³⁸, the failures of US and Swiss regional banks in early 2023 have shown that even with the common backstop in place, the amount of funds available for resolution may be fully used or insufficient in the case of a failure of a global bank or of several medium-sized banks. While this scenario remains a tail-risk, it nevertheless should not be ignored.

The common backstop is expected to replace the direct bank recapitalisation instrument (DRI). If the revised ESM Treaty does not enter into force in the course of 2024, a comprehensive review of the guideline on the DRI should be performed to prepare a decision on the continuation of this instrument.

2.5.1 Size of the Backstop

The ESM Backstop Guideline foresees that the ESM BoG shall establish the nominal cap of the backstop. This nominal cap will limit the size of the backstop facility. Another important parameter, the maximum amount established when granting the backstop facility, will at all times be equal to or lower than the nominal cap. While the BoG establishes the maximum amount for the first time when granting the backstop, the ESM Board of Directors (BoD) may revise the maximum amount. The maximum amount is aligned with the euro area pro-rata share of ex-ante contributions to the target level of the SRF but is not higher than the nominal cap. Upon notification by the SRB or as part of a review of the instrument (regular – every 3 years, or comprehensive – every 10 years), the maximum amount can be revised by the BoD by mutual agreement to align it with the euro area share of the SRF target level up to the level of the nominal cap. The target level of the SRF is at least 1% of covered deposits in the banking union.

The nominal cap of the backstop facility is set at €68 billion in the draft ESM reform documents. However, the SRF has reached its target size, slightly over 1% of the total amount of covered deposits in the banking union, that is €78 billion at the end of 2023³⁹. This is higher than what had been expected when the backstop was being negotiated. The increase in the size of the SRF is due to the higher level of deposits in the banking system and is also a consequence of the excess savings accumulated by households and firms during the pandemic. According to the SRB, “after 2023 the SRB will only collect the amount necessary to cover for the annual growth of covered deposits, with the aim of fulfilling at all times the legal obligation to keep an SRF reflecting 1% of covered deposits of all credit institutions in the banking union”.⁴⁰ The nominal cap of the backstop can only be increased by a BoG decision and as such entails a political agreement among the ESM Members, subject to required national procedures where applicable.

³⁸ [SRB Bi-annual reporting note to Eurogroup, 13 May 2024](#)

³⁹ [SRB bi-annual reporting note to the Eurogroup, 13 May 2024.](#)

⁴⁰ [SRB bi-annual reporting note to the Eurogroup, 7 November 2022.](#)

2.5.2 Implications for the ESM Lending Capacity

The expected evolution of the size of the SRF may reopen discussions about the nominal cap of the backstop. In light of the increasing size of the SRF, a request could be made by the SRF to the ESM to increase the size of the backstop facility. In case such a request is made, it is important to consider all relevant parameters.

Given the increasingly uncertain global environment and downside risks to the economic outlook in Europe, the ESM needs to ensure that it has sufficient lending capacity to support both the euro area sovereigns and the banking system. As for the size of the backstop, an incremental increase would not put at risk the ESM's credit rating as long as the maximum ESM lending volume remains unchanged. Rating agencies deem that the backstop will contribute to the diversification of the ESM loan portfolio, which so far included only sovereign exposures. However, should these increases be more significant, concerns about the ESM's ability to provide enough support to its larger Members may arise. In case an increase of the nominal cap is requested, the decision of the BoG should take into account all relevant considerations, including the impact on the overall ESM lending capacity, credit rating, and the firepower available to support sovereigns.

The ESM's lending capacity is formally enshrined in the so-called forward commitment capacity, which is regularly updated and published on the ESM's website. According to the revised draft Forward Commitment Capacity Guideline, the maximum amount of the backstop will be discounted fully from the ESM's lending capacity, since the SRB will be entitled to request the entire amount at any time and re-borrow any repaid amounts.

Key findings

As regards the common backstop, the SRF size has grown larger than anticipated at the time of the ESM reform, while the then agreed framework provides for the possibility to adjust the size of the backstop, if needed. Any discussion on increasing the nominal cap under the backstop could take place after the entry into force of the revised ESM Treaty and would need to consider that the ESM lending capacity must remain adequate to support both the euro area sovereigns and the banking system.

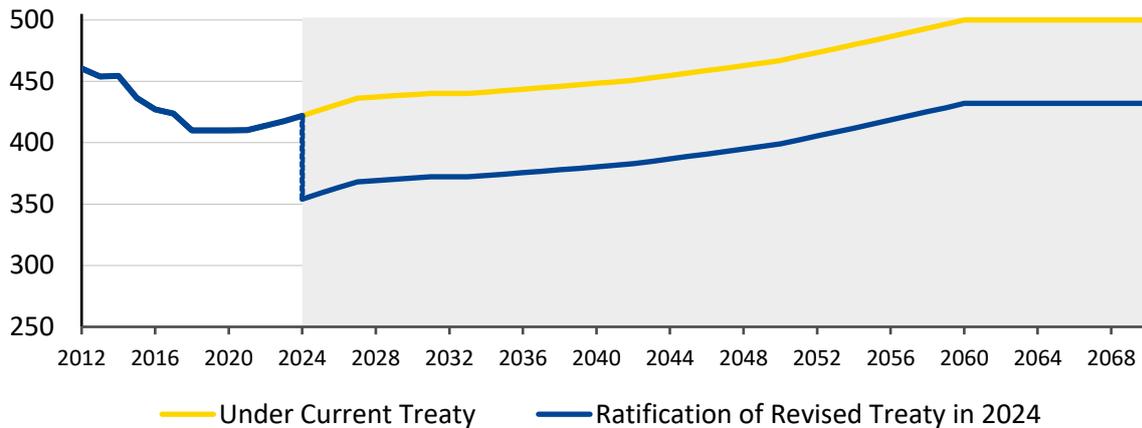
The common backstop is expected to replace the direct bank recapitalisation instrument (DRI). Yet, if the revised ESM Treaty does not enter into force in the course of 2024, a review of the DRI guideline should be performed to prepare a decision on its continuation.

3. Adequacy of the lending volume and authorised capital stock

The evolving economic environment in the euro area and the evolution in the ESM instruments will determine future needs for ESM resources. Based on the following assessment, and in line with the latest review completed by the BoG in June 2022, a sufficient level of the ESM lending capacity should be maintained to uphold the confidence in the euro area financial architecture.

A large part of the total ESM lending capacity remains available to provide support for preserving the euro area financial stability, if required. The ESM available lending capacity out of the €500 billion maximum amount has decreased from €461 billion in 2012 to €422 billion in April 2024, reflecting the financing provided under the financial assistance to Cyprus, Greece and Spain. The remaining lending capacity is set to fall, assuming the full ratification of the revised ESM Treaty where it is foreseen that €68 billion will be earmarked for the backstop to the SRF (Figure 7). Absent of any new programmes, under the current repayment schedules of the beneficiary Member States, a gradual increase in the available lending capacity is then projected until 2060 (€432 billion), at which point the only committed portion of the ESM lending capacity would be under the common backstop, assuming that the facility is extended by then.⁴¹

Figure 7.
ESM remaining lending capacity
(in € billion)



Source: ESM

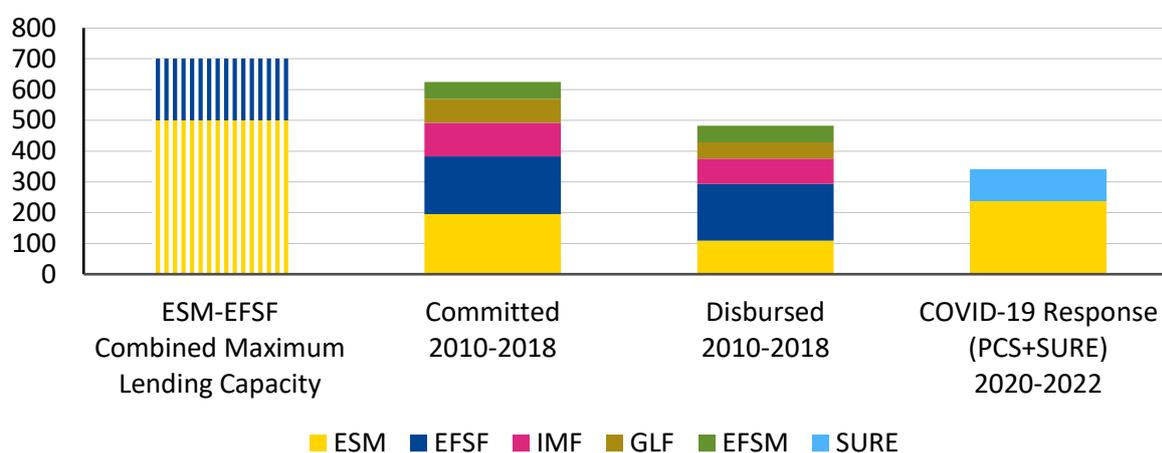
Note: The maximum lending volume of the ESM is €500 billion. From 2023, the data points are projections based on current repayment schedules of beneficiaries of ESM financing. The distance between the curves from 2023 reflects the possible introduction of an up to €68 billion backstop of the SRF by the ESM, which is subject to full ratification of the revised Treaty. The backstop is added under the assumption that the current size of its nominal cap (€68 billion) is not revised in the future.

The combined lending capacity of the ESM and EFSF managed to support euro area financial stability in the past while the maximum lending capacity has slightly declined against macroeconomic aggregates over the period. At the ESM's inception in 2012, the BoG set the maximum lending volume at €500 billion and confirmed the combined lending ceiling of the ESM and the EFSF at €700 billion (Figure 8). As of July 2013, the EFSF may no longer engage in new financing programmes, leaving the remaining ESM lending capacity as the main component of the euro area safety net. In the absence of

⁴¹ The initial availability period of the backstop facility shall be ten years, and will be extended automatically for further ten-year periods, except under the circumstances envisaged in the *European Stability Mechanism Guideline on the backstop facility to the SRB for the SRF*, Article 12.

forecasted future demand for ESM financing, a backward-looking approach may provide some insights for the adequacy of the lending capacity. The ESM lending capacity is smaller than the total past programme amounts committed (€625 billion) and greater than the total past programme amounts disbursed (€483 billion) over the 2010-2018 period by arrangements dedicated to the euro area (Greek Loan Facility, EFSM, EFSF, ESM, and the IMF) (Figure 8). Having available lending capacity at the onset of the Covid-19 pandemic enabled the ESM to contribute to the common European response with a significant envelope. These past commitments may not be fully indicative of future needs for ESM support considering the evolving economic aggregates, the prevailing economic uncertainty and the existence of potential risks to financial stability on the one hand, nor can they reflect the advancements in the economic governance and crisis resilience since the sovereign debt crisis on the other. As the pivotal part of the euro area financial safety net, the ESM lending volume should be maintained at a sufficiently high level considering the evolution of main macroeconomic and fiscal aggregates, such as GDP, debt, and revenues (Figure 9).

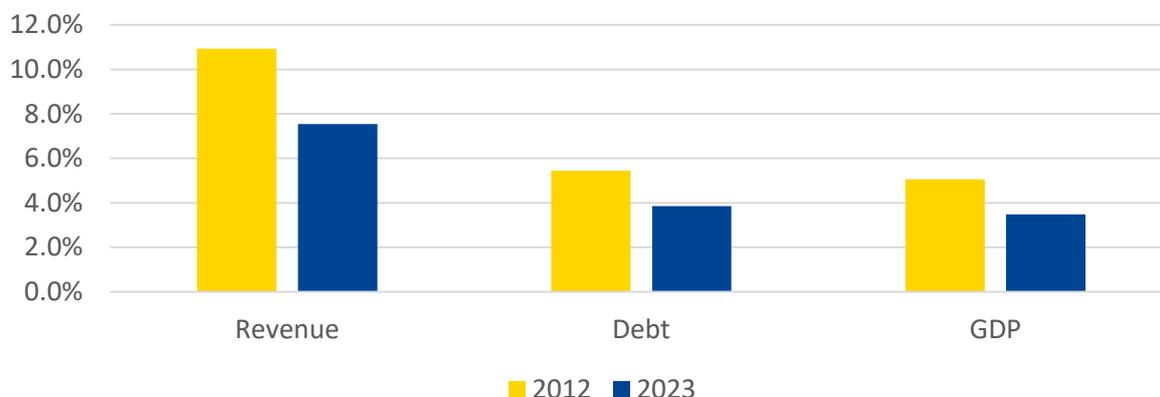
Figure 8.
ESM and other financial assistance sources
(in € billion)



Source: ESM, European Commission, IMF, ECA

Note: Amounts committed and disbursed are part of financial assistance programmes to euro area countries in 2010-2018. The COVID-19 response envelope is comprised of the ESM's PCS, and of the European Commission's SURE. Under the PCS, up to 2% of euro area GDP as of end-2019 (€240 billion) was made available by the ESM, though no financing requests were made. The SURE envelope size of €100 billion was available to all EU27 Member States.

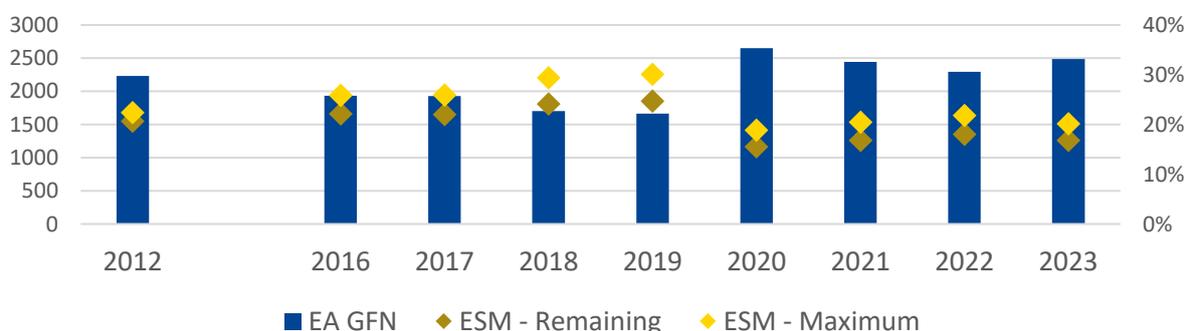
Figure 9
ESM maximum lending capacity expressed as share of selected euro area macroeconomic aggregates
 (2012 vs. 2023)



Source: ESM, European Commission, ECB
 Note: Euro area in rolling composition

Against the metric of gross financing needs, both the ESM maximum and remaining lending capacity have declined in recent years. Debt sustainability is intrinsically linked to both stock and flow features of public debt, from which vulnerabilities can arise from term-to-maturity structures, roll-over risks, amortisation schedules and varying interest rates. As highlighted by ESM staff research (Gabriele et al., 2017), gross financing needs (GFNs) is a comprehensive flow metric for identifying such mismatches. Since the creation of the ESM in 2012, GFNs have declined within the prevailing low-interest environment (Figure 10). Within this context, the ESM maximum and remaining lending capacity reached their peak as a share of euro area GFNs in 2019 at 29% and 24% respectively. Since 2019 however, GFNs have increased considerably given the onset of the Covid pandemic and the subsequent energy crisis, reversing this trend. In 2023, only 20% of euro area GFNs could be covered by the ESM maximum lending capacity (16% for the remaining capacity), below the levels prevailing in 2012.

Figure 10.
ESM lending capacity as a share of euro area gross financing needs, 2012 - 2022
 (left hand scale: EA GFN in € billion, right hand scale: ESM lending capacity in % of GFN)



Source: ESM, European Commission
 Note: Given their volatile nature, changes in methodology, and incomplete data-series, a full time-series of gross financing needs for the 2012-2023 period is not presented.

The relative size of the ESM lending capacity is expected to improve in the medium term; however, several trends point to a gradual decline in the long run. A phasing-out of energy crisis measures through appropriate fiscal efforts would naturally improve the weight of the ESM lending capacity against both euro area debt and GFNs. As noted by the 2024 Commission Spring Forecast, the euro area debt-to-GDP ratio is projected to decrease slightly by the mid-2020s, falling from 92.4% of GDP in 2022, to 90.4% by 2025. Given the need for debt consolidation in the next few years, GFNs are expected to diminish from their recent peaks (from 23.0% of euro area GDP in 2020 to 16.9% in 2025⁴²). However, in the medium to long run, structural factors – such as ageing costs and the green transition – may increase GFNs, and thus reduce the relative ESM firepower.

The small increases in the ESM capital since inception due to the accession of new Members do not seem to warrant an increase of the lending capacity. The ESM has an authorised capital stock of €708.49 billion, out of which €80.97 billion is paid in. The strong capital structure of the ESM serves as the foundation of its lending capacity and determines its credit ratings. It also underscores the support by the ESM Members. The ESM subscribed capital and the reserve fund – which provides an additional source of balance sheet strength – have increased since its establishment. Nevertheless, these increases do not lead to an increase in the maximum lending volume without risks to the ESM’s AAA ratings. In fact, an increase in the ESM maximum lending capacity would imply a deviation from the 15% ratio between shareholders’ equity and the maximum lending capacity, which some rating agencies have been considering in their assessments since inception.

Key Findings

The ESM’s maximum lending volume has supported the euro area financial stability up to now while a significant amount of the lending capacity remains available. Since the ESM’s firepower has been kept unchanged since the inception of the ESM, a slight decline can be expected relative to the main macroeconomic aggregates. At the same time, the improved overall safety net for the euro area, regulatory provisions, and ongoing efforts to pursue further advances through the capital markets union and banking union may reduce the need to use the ESM lending capacity. The ESM’s maximum lending volume and authorised capital stock remain adequate at present.

⁴² See [European Commission - Debt Sustainability Monitor 2023](#)

4. Final remarks

The euro area's resilience has been repeatedly tested in the recent years further straining the fiscal space of its member states. Since the ESM was founded, significant progress has been made to deepen the Economic and Monetary Union and further strengthen its architecture. In this context, the report elaborates how the ESM's stability support instruments and lending capacity can address emerging challenges within the bounds of the institution's mandate.

In a shock-prone world, evolving regulatory framework, and a changing European institutional landscape, the ESM instruments need to remain relevant and complementary with the euro area economic governance. Drawing from over one decade of the institution's experience in crisis resolution, this report is the first comprehensive review of the ESM's instruments and lending capacity. It puts forward several key findings and identifies follow-up work areas that could be addressed within the existing or the revised ESM Treaty.

The report finds that the ESM toolkit and its lending capacity provide a strong basis to stand up to the emerging challenges and could be optimised by further developing the preventive instruments and refining the associated processes, which would tackle the stigma. The existing ESM precautionary instruments could be used in response to a shock and to preserve financial stability while these tools could become more effective by exploring their refinement through a dedicated instrument. Such instrument would complement the existing precautionary instruments, which would retain their insurance role aiming to preserve market access. It would also imply a signalling effect and tackle stigma by way of creating an innovation addressed at finding a permanent financial support to cope with the recurring emerging risks and breaking away from the past euro area crisis. In addition, the processes surrounding requests, notably the confidential consultations, could be enhanced, by foreseeing group requests for assistance and aiming to reduce the information asymmetries between potential ESM beneficiaries and the institutions involved in the procedures. Furthermore, the eligibility criteria for precautionary instruments under the revised Treaty should be aligned with the reformed Economic Governance Framework.

A large part of the total ESM maximum lending volume remains available to provide support for preserving the euro area financial stability, if required. The ESM's maximum lending volume and authorised capital stock require regular review yet remain adequate at present. This assessment strikes a balance between the fact that the maximum lending volume has remained unchanged since inception despite an increase in the relevant fiscal and economic benchmarks on the one hand and the improved overall safety net and regulatory landscape in the euro-area on the other. Currently, the ESM maximum lending volume cannot increase without an adverse effect on its credit ratings. That is why, for example, a possible discussion on whether to allocate a greater share of the ESM lending capacity to the common backstop by raising the nominal cap would need to consider the need to find an appropriate balance between the ESM instruments to support the euro area sovereigns and the banking system within the limits of the existing maximum lending volume.

Annex A. Potential interest savings from the use of the PCS

Table 4.
Potential interest savings from the use of the PCS credit line

(a) ... in May 2020

	PCS benchmark size	10y yields	Spread vs ESM	Annual savings	Cumulative 10-year savings
	bn €	%	%	mn €	mn €
IT	35.8	1.59	1.62	580	5,690
ES	24.9	0.62	0.64	160	1,540
GR	3.7	1.69	1.71	60	630
PT	4.2	0.73	0.75	30	310
SK	1.9	0.51	0.53	10	100
IE	6.9	0.11	0.14	10	80
SI	1	0.7	0.73	10	70
CY	0.4	1.2	1.23	10	50
BE	9.5	0.03	0.05	10	30
LT	1	0.34	0.36	0	30
EE	0.6	0.34	0.37	0	20
MT	0.3	0.61	0.63	0	20
LV	0.6	0.22	0.24	0	10
AT	8	-0.12	-0.09	0	0
FI	4.8	-0.14	-0.11	0	0
FR	48.4	-0.04	-0.02	0	0
DE	68.7	-0.49	-0.47	0	0
LU	1.3	-0.19	-0.16	0	0
NL	16.2	-0.25	-0.23	0	0
Total	238.1			880	8,570

(b) ... in September 2020

	PCS benchmark size	10y yields (3m average)	Spread vs ESM	Annual savings	Cumulative 10-year savings
	bn €	%	%	mn €	mn €
IT	35.8	1.13	1.25	447	4,383
ES	24.9	0.40	0.52	129	1,227
GR	3.7	1.15	1.27	48	467
PT	4.2	0.41	0.52	22	212
CY	0.4	0.90	1.02	4	44

IE	6.9	-0.04	0.07	5	33
LT	1.0	0.20	0.32	3	29
SI	1.0	0.16	0.27	3	24
MT	0.3	0.64	0.75	2	19
EE	0.6	0.24	0.35	2	18
LV	0.6	-0.01	0.11	1	5
SK	1.9	-0.13	-0.02	0	0
FR	48.4	-0.14	-0.02	0	0
BE	9.5	-0.16	-0.04	0	0
AT	8.0	-0.25	-0.13	0	0
LU	1.3	-0.28	-0.16	0	0
FI	4.8	-0.26	-0.14	0	0
NL	16.2	-0.31	-0.20	0	0
DE	68.7	-0.45	-0.34	0	0
Total	238.1			666	6,461

(c) ...in November 2020

	PCS benchmark size	10y yields (3m average)	Spread vs ESM	Annual savings	Cumulative 10-year savings
	bn €	%	%	mn €	mn €
IT	35.8	0.81	1.01	360	3,506
ES	24.9	0.21	0.40	100	938
GR	3.7	0.94	1.13	42	415
PT	4.2	0.20	0.40	17	158
LT	1.0	0.16	0.35	3	32
CY	0.4	0.50	0.69	3	29
EE	0.6	0.24	0.43	2	23
MT	0.3	0.46	0.65	2	17
SI	1.0	-0.06	0.13	1	10
LV	0.6	-0.08	0.11	1	5
IE	6.9	-0.19	0.00	0	0
SK	1.9	-0.28	-0.09	0	0
FR	48.4	-0.26	-0.07	0	0
BE	9.5	-0.31	-0.11	0	0
AT	8.0	-0.37	-0.18	0	0
FI	4.8	-0.35	-0.15	0	0
LU	1.3	-0.33	-0.14	0	0
NL	16.2	-0.43	-0.24	0	0
DE	68.7	-0.53	-0.34	0	0
Total	238.1			532	5,132

Source: ESM

Notes: 3-month average -Yields as of 22 May 2020 (a) up to 4 September 2020 (b) and up to 24 November 2020 (c)

The spread vs ESM excludes the upfront service fee of 25bps, which is a one-off and paid in the first year. The PCS credit line cost includes a 10bps annual margin and a 0.5bps annual service fee. Upfront fees are assumed to be spread over the 10 years, without impact on cumulative savings. The yield for Estonia is based on the 10-year bond issued on 3 June 2020.

Annex B: Frameworks for own-fund items and resolution of insurance companies and investment firms

Both insurance companies and investment firms have regulatory capital and can, in principle, be recapitalised via debt instruments and share purchases. In the specific case of insurance firms, national rules should also be checked in case of a recapitalisation.

Investment Firms

Generally, investment firms are divided into three classes under Directive (EU) 2019/2034 (IFD) and Regulation (EU) 2019/2033 (IFR) which aim to reflect the nature, size, and complexity of the respective investment firms' activities and provide a corresponding regulatory framework:

- Class-1 firms are investment firms that are engaged in dealing on own account, underwriting or placing financial instruments on a firm commitment basis and meet a EUR 30 bn threshold for their consolidated assets ("**Class-1 Firms**").
- Class-3 firms, which are small and non-interconnected firms ("**Class-3 Firms**"), and
- Class-2 firms, which can neither be classified as class-3 firms, nor as class-1 firms ("**Class-2 Firms**").

The resolution regime for investment firms is similar to that of banks and is harmonised for certain investment firms, following the BRRD/SRMR rules. **Class-1 Firms** may be subject to the BRRD since they qualify as credit institutions under the Regulation (EU) No 575/2013 (CRR) and hence, under the Directive (EU) 2014/59 (BRRD). The BRRD also applies directly to certain **Class-2 Firms**.⁴³

The above-mentioned **Class-1 and Class-2 Firms** could – in principle – be recapitalised via IRI under the current legal framework, provided also that state aid rules are complied with. As such, the granting of funds via the ESM's loans would have to be confined to solvent entities, be of a precautionary and temporary nature, be proportionate to remedy the consequences of the serious disturbance, and not be used to offset losses that are incurred or likely to be incurred in the near future.

Insurance Companies

The requirements for the own funds of insurance undertakings are set out in Directive 2009/138/EC (Solvency II), which was implemented into national laws accordingly. The resolution of insurance companies is determined by national legal regimes.

A recapitalisation of an insurance undertaking by an ESM Member using Loans from the ESM would need to comply with Art. 18 para. 1 of Solvency II which requires insurance undertaking "*to limit their objects to the business of insurance and operations arising directly therefrom, to the exclusion of all other commercial business*". In some countries, for example, this requirement has been implemented to the effect that insurance undertakings are, in principle, prohibited from raising debt (unless such

⁴³ Investment firms which require an initial capital of EUR 750,000 under the IFD are subject to the harmonised resolution framework under BRRD pursuant to Art. 1 para. 1 lit. a) BRRD. Pursuant to Art. 9 para. 1 IFD, such initial capital is required for an investment firm that carries out the investment services of "dealing on own account" and/or "underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis". Accordingly, the BRRD does apply directly only to certain Class-2 Firms. Class-3 firms are excluded from this analysis due to their non-systemic nature.

debt instrument meets the regulatory conditions for an own-fund item).⁴⁴ In this case, the recapitalisation conferred by the respective ESM Member via a debt instrument would therefore need to be structured to the effect that such instrument meets the requirements of a restricted Tier 1 own fund item or Tier 2 own fund item.

A proposal for harmonisation (IRRD) of insurance companies' resolution regimes has not been finalised – and would not allow extraordinary public financial support in the same way as BRRD does, finalised as currently drafted. Although the preamble of the IRRD proposal mentions that extraordinary public financial support could be provided, as a last resort, Art. 19(3)(d) specifies that an insurance/reinsurance undertaking shall be considered failing or likely to fail in case extraordinary public financial support is required. Unlike the BRRD, there are no exceptions to this rule (e.g. precautionary recapitalisation). There are also no government financial stabilisation tools allowed in resolution.

⁴⁴ *Brand*, in: HK-VAG, 1. Aufl. 2018, VAG § 15 Rn. 65

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