

European but not EU – the special case of ESM and EFSF

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Secretary General

ESM and EFSF



What are the ESM and EFSF?

- ESM founded in 2012 (EFSF est. 2010)
 - ESM: International Financial Institution, similar to IMF, WB and EBRD
 - EFSF: Private company under Luxembourg law (as of 1 July 2013 no longer engages in new programmes)

- EFSF/ESM combined balance sheet of €947 bn. ESM subscribed capital €702 bn., paid-in capital €80,2 bn. Combined lending capacity €692 bn. (€ 450 bn. available at the ESM)
 - ESM has the largest paid-in capital of any International Financial Institution worldwide

- Total lending €238 bn. (Greece, Portugal, Ireland, Spain and Cyprus)
 - Disbursed three times as much in Europe as IMF in the same period globally
 - Excellent rating allows for cheap loans to countries (3-6 month bills negative rate)

- Total amount of bonds issued by EFSF and ESM: €343.6 bn

- ESM shareholders: 18 euro area Member States (with Lithuania will become 19)

- Approximately 140 staff members recruited across the globe

What have we accomplished?

- 1 The EFSF/ESM ensured that all euro area countries stayed in the euro
- 2 Our programme countries have become the reform champions of Europe
 - EFSF/ESM programme countries are top performers in reforms in the EU and OECD
- 3 EFSF/ESM lending significantly improved debt sustainability in the programme countries
 - EFSF/ ESM loans not only provide emergency financing against conditionality, but also include substantial solidarity (beyond traditional IMF approach)
 - Annual budget savings in Greece of €8.5 billion per year (or 4.5% of Greek GDP)
 - Budget savings in Ireland, Portugal, Cyprus and Spain are smaller but still significant
- 4 EFSF and ESM lending took some pressure off the ECB

Reform champions: structural reforms support the sustainability of the effort

- **Greece, Ireland, Portugal and Spain** are in top 5 of 34 OECD countries with regard to implementation of structural reforms. Policy areas concerned:
 - Labour productivity (e.g. product market regulation, human capital)
 - Labour utilisation (e.g. labour market regulation, social welfare system, active labour market policies)

Ranking in OECD report
1. Greece
2. Ireland
3. Estonia
4. Portugal
5. Spain

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

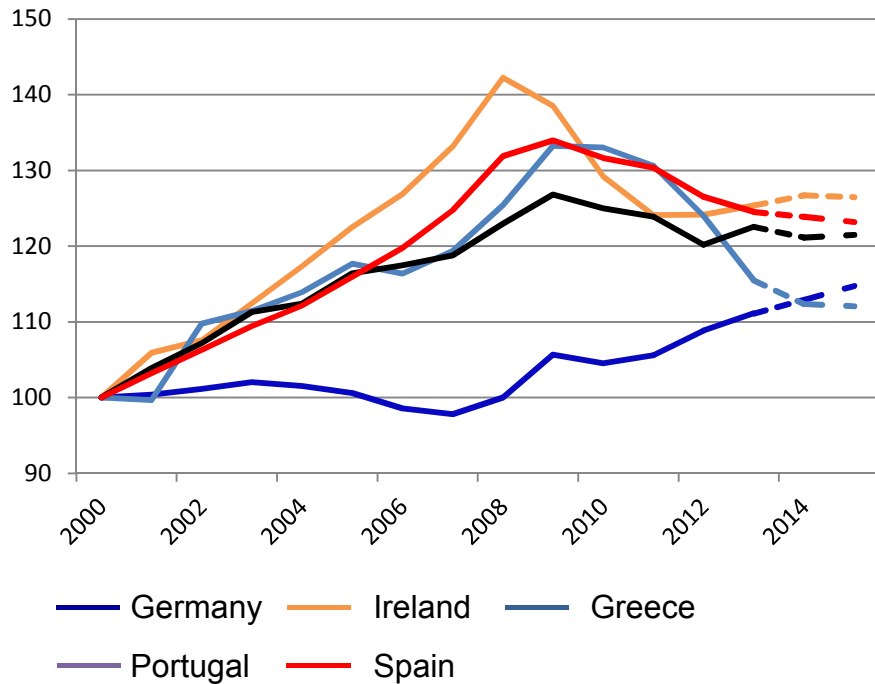
- *Going for Growth 2013* (OECD Report)

Source: OECD report *Going for Growth 2013*
Ranking takes into account responsiveness to OECD recommendations on structural reforms in key policy areas

Internal devaluations are restoring competitiveness

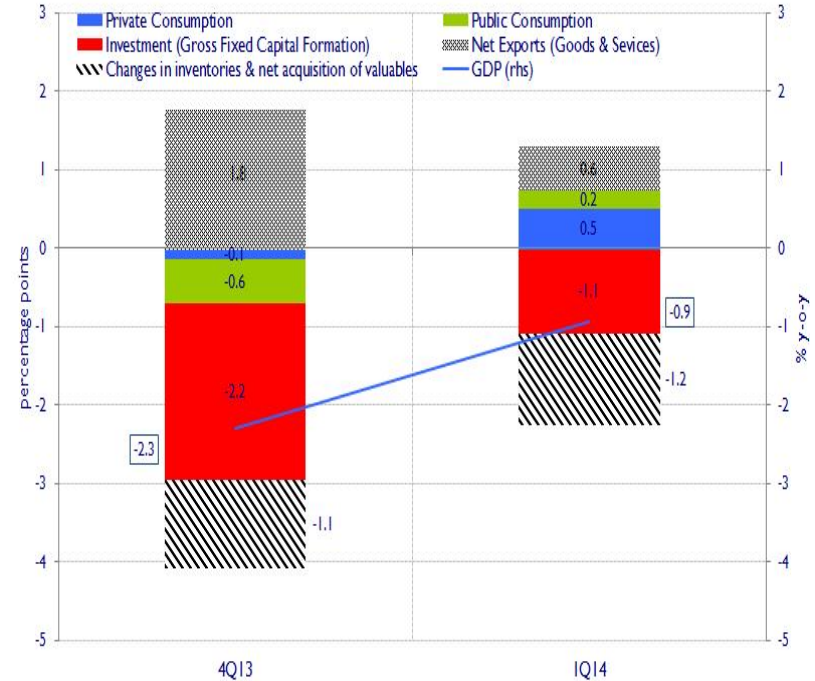
- Thanks to the convergence in competitiveness, costly external imbalances in the periphery have corrected

Nominal unit labour costs (2008=100)



Source: EC European Economic Forecast - Spring 2014

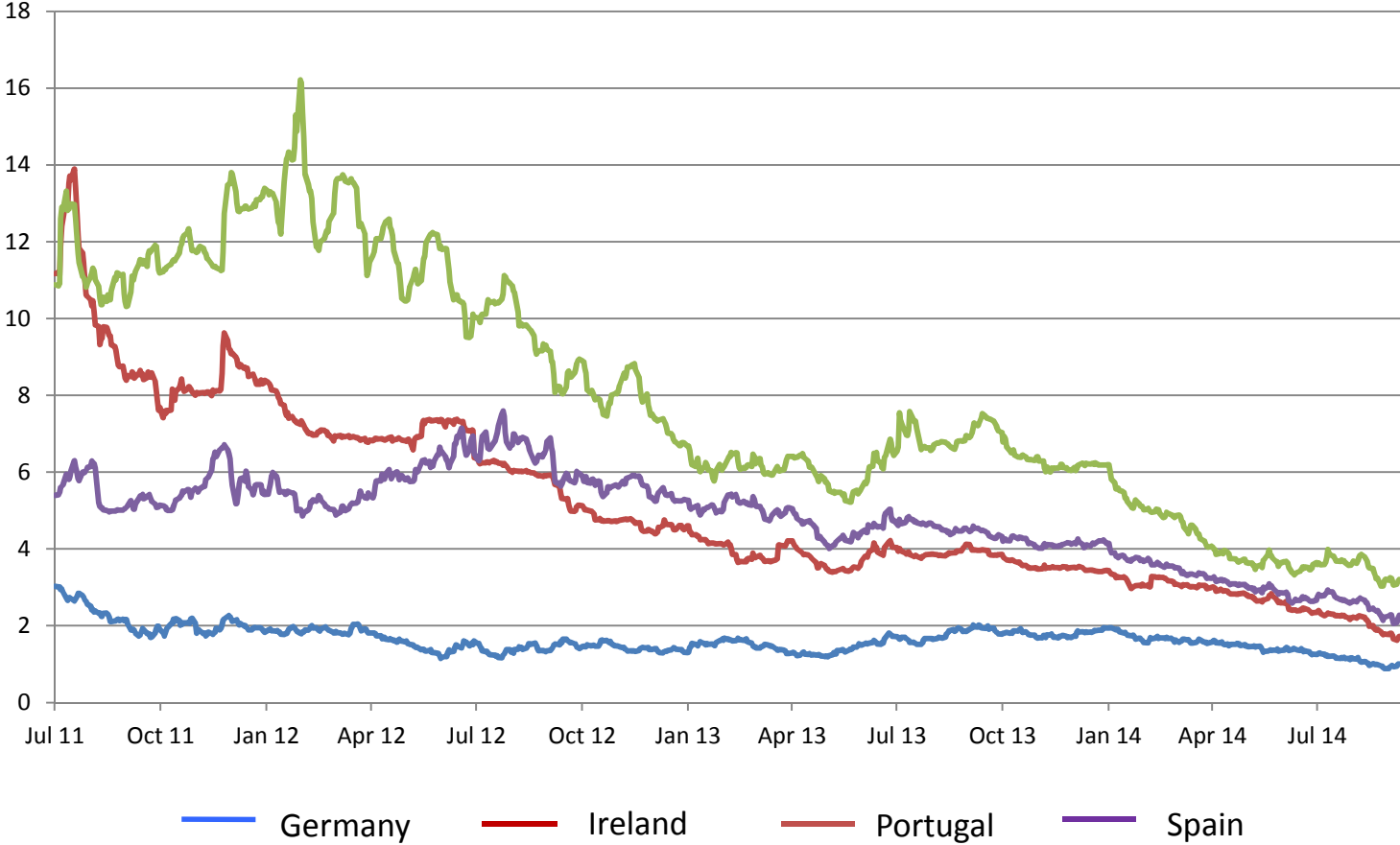
Greece - Contribution to growth (%)



Source: Eurostat, Balance of Payment definition

Risk premia have fallen in the euro area

10-year government bond yields (%)



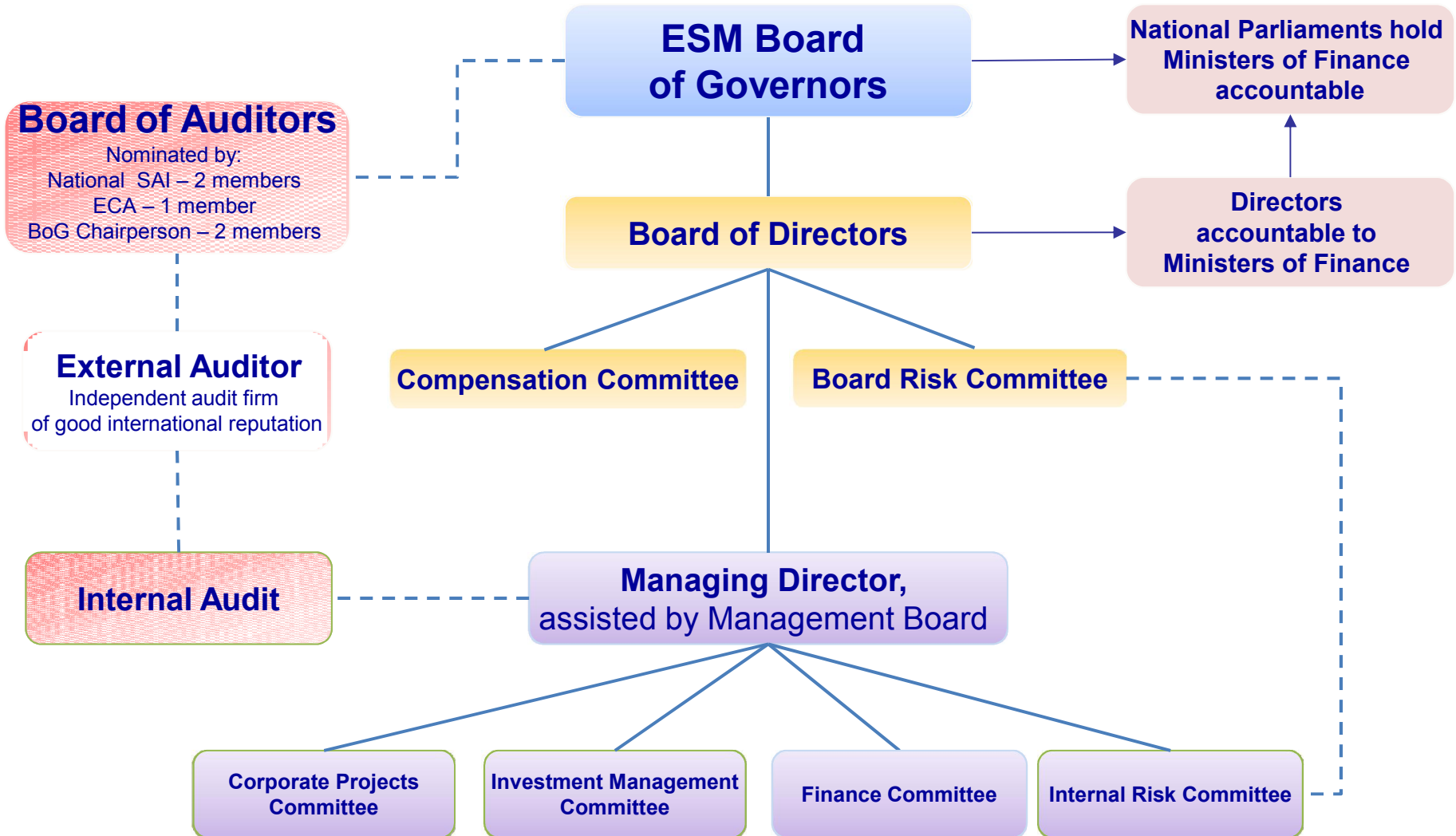
Source: Bloomberg

Governance and audit oversight



The ESM Board of Governors with the ESM Managing Director Klaus Regling

How is ESM audited?



Governance and audit oversight

- Accountability and audit oversight are important considerations for the ESM and EFSF
- A full-fledged financial institution with front, middle and back office
- For its small size (140 staff), the institution has a high level of governance and audit oversight:

Governance

- ESM 24 meetings: 6 BoG, 10 BoD, 4 Compensation Committee and 4 BRC meetings in 2013
- EFSF 14 meetings: 14 BoD meetings and an annual general meeting of shareholders in 2013

Audit

- ESM 9 people / 41 onsite days: 5 Board of Auditors members, supported by a field team of 4 experts from the ECA and German SAI: 11 meetings/21 days; 2 audits/10 days in 2013
 - EFSF: Audit Committee composed of 5 members of the Board of Directors
 - External audit team 6 people / 85 days: 4 months at our premises to audit ESM and EFSF annual accounts
 - Internal audit: 4 audits performed in 2013 (9 audits in progress in 2014)
- On a voluntary basis and upon invitation, the MD and MB members visit parliaments (European and national)

Governance and audit oversight (2)

- Many ESM Members have **national procedures** where consultation or approval by the national parliament / committee is required prior to BoG / BoD decisions
- The **Board of Governors (euro area Finance Ministers)** takes key decisions by mutual agreement, i.e. to provide stability support; make capital calls; adapt the maximum lending volume; change the financial assistance instruments (DRI); to change the pricing policy for financial assistance, etc.
- The **Board of Governors** serves to **discharge the annual accounts** which are audited by a private external auditor
- The **Board of Directors** ensures that the **ESM is run in accordance** with the Treaty and the By-Laws and draws up the annual accounts
- The **Board Risk Committee** reviews the overall risk appetite, risk profile and internal control of the organisation
- Internally, the ESM has implemented the **three lines of defence** governance model across the organisation (Business lines - Risk Management - Internal Audit)

ESM Board of Auditors: Composition and Terms

- ESM not within the ECA mandate (ESM is not an EU institution, does not use EU funds) & Parallel audits by the 19 national SAI of the ESM Members not feasible
- **Board of Auditors** - Independent audit body appointed by the Board of Governors:
 - Two members upon proposal of the national SAI of two ESM Members (based on a system of rotation)
 - One member upon proposal of the ECA
 - Two members upon proposal of the Chairperson of the Board of Governors
- All members serve in their personal capacity for a non-renewable term of three years.



Ulrich Graf
Chairperson
(nominated by
German SAI)



Igors Ludboržs
Vice-Chairperson
(nominated by
ECA)



Marc Gengler
Member
(nominated by
Luxembourg SAI)



Katarína Kaszasová
Member
(nominated by BoG
Chairperson)



Jules Muis
Member
(nominated by
BoG chairperson)

ESM Board of Auditors: Mandate

- Broad mandate pursuant to the ESM Treaty and By-Laws:
 - **Inspect the ESM accounts** and verify that the ESM operational accounts and balance sheet are in order

 - **Perform independent audits of:**
 - » Regularity
 - » Compliance
 - » Performance
 - » Risk management of the ESM

 - **Monitor the ESM internal and external audit** processes and their results.

- The Board of Auditors has full access to any document and information of the ESM needed for the implementation of its tasks

ESM Board of Auditors: Activities

■ Regular meetings

- Meetings with the ESM management (2013: 11 meetings, 21 days)
- Meetings with the internal and external auditors
- Annual meetings with the Chairperson of the Board of Governors, the Board of Directors and the Board Risk Committee

■ Independent audits of the ESM

- 2 audits/ 10 days in 2013 conducted with support by German SAI and ECA experts
- 2 audits in 2014

■ Monitoring of the ESM internal and external audit processes and their results

- Monthly meetings with the internal auditor
- Regular meetings with the external auditor and review of their audit working papers

Extensive reporting to shareholders

■ ESM and EFSF report extensively to the shareholders (Ministries of Finance):

Weekly

- EFSF available funds report

Monthly

- ESM/EFSF lending and funding cash flows
- ESM/EFSF redemption profile report
- ESM/EFSF daily applicable rate
- ESM cash position
- EFSF guarantee consumption report

Quarterly

- ESM/EFSF financial results
- ESM/EFSF investor base
- ESM/EFSF outstanding issuance report
- Reports on the ESM/EFSF funding, lending and investment programmes

Annually

- ESM Annual Report - available to the general public on the ESM website
- EFSF Annual Financial Statements and Management Report - available on the EFSF website

In closing

- Compared to similar institutions, ESM is subject to a very high level of **governance and audit oversight** reflecting the importance of its mandate
- All key decisions are taken by the Board of Governors (in many cases **subject to national parliament procedures**)
- Extensive reporting to the shareholders/Ministries of Finance, which in turn report to national parliaments/committees.
- The ESM Board of Auditors is **a robust audit mechanism**:
 - Independent body appointed by the Board of Governors
 - Broadest mandate among all IFIs – inspects the ESM accounts and performs independent audits
 - Right of access to all necessary information
 - The Board of Auditors' Annual Report is sent to euro area national parliaments, SAI, the European Parliament and the ECA

Contacts

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Annex

EFSF & ESM: Key Features



Legal Structure	Private company under Luxembourg law	Inter-governmental institution of the euro area Member States under public international law
Duration	Temporary (June 2010 - June 2013*)	Permanent institution
Capital structure	Backed by guarantees of euro area Member States	Subscribed capital of €701.9bn** €80.2bn in paid-in capital
Maximum Lending capacity	€192bn already committed to Ireland, Portugal & Greece* No engagement in new financing programmes	€500bn
Creditor status	Pari passu	Preferred creditor status (after IMF) ***
Credit Rating	AA / Aa1 / AA+	- / Aa1 / AAA
Risk Weighting	0%****	0%****

* As of 01/07/2013, EFSF may no longer engage in new financing programmes

** The initial subscribed capital of €700 bn has increased since the accession of Latvia in March 2014

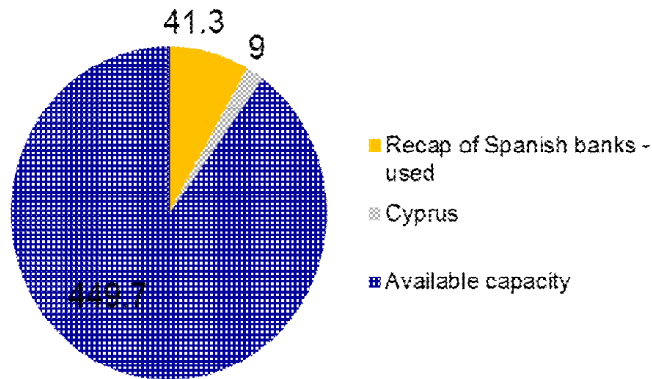
*** For the financial assistance for recapitalisation of the Spanish banking sector, pari passu will apply

**** Regulation (EU) no. 575/2013 (Capital Requirements Regulation), Article 118. Following a decision published by the Basel Committee on Banking Supervision on 18 March 2014, EFSF & ESM securities will be included in the list of entities receiving a 0% risk weighting under Basel II

EFSF & ESM: Lending Capacity

EUR billion

ESM - €500 billion



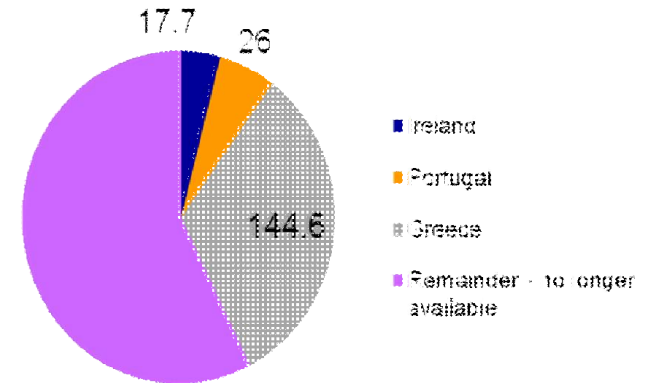
Recapitalisation of Spanish banking sector

- Date Agreed: November 2012
- Concluded: December 2013
- Amount disbursed: €41.3 bn

Programme for Cyprus

- Date Agreed: March 2013
- Duration: Q2 2013-Q1 2016
- Amount committed: approx. €9 bn
- Amount disbursed: €4.75 bn

EFSF - €440 billion



Ireland

- Date Agreed: November 2010
- Concluded: December 2013
- Amount disbursed: €17.7 bn

Portugal

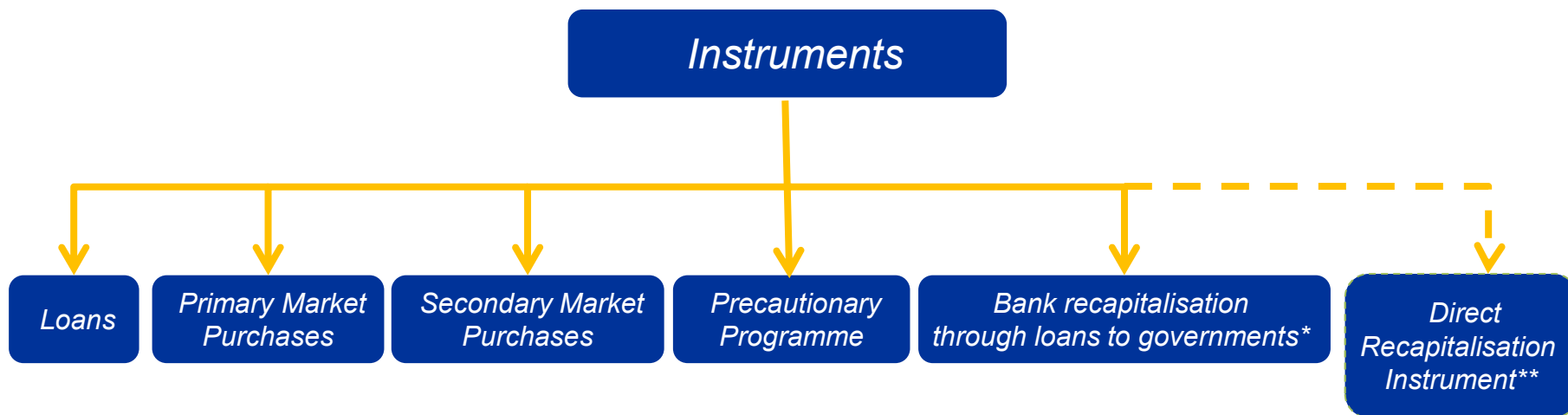
- Date Agreed: May 2011
- Concluded: 2011-mid 2014
- Amount disbursed: €26 bn

Greece

- Date Agreed: March 2012
- Duration: 2012-2014
- Amount committed: € 144.6bn
- Amount disbursed: €139.9 bn

EFSF & ESM: Mission and Instruments

ESM mission : to safeguard financial stability in Europe by providing financial assistance to euro area Member States



All assistance is linked to appropriate conditionality

EFSF and ESM finance their activity by issuing bonds or other debt instruments

* Can be granted to an ESM Member outside the confines of a macroeconomic adjustment programme

** The Direct Recapitalisation Instrument will be established through a resolution by the ESM Board of Governors pursuant to Article 19 of the ESM Treaty. Activation of the DRI is subject to the unanimous approval of all euro area Member States.

EFSF: Governance and audit oversight

- Many EFSF shareholders have national procedures where consultation or approval by the national parliament/committee is required. Some national parliaments require regular reporting on EFSF
- All major decisions beyond the daily business of the Company are made by the EFSF Board of Directors. The Board comprises of high level representatives of 17 euro area Member States (ex new ESM Members – Latvia and soon Lithuania)
- Audit Committee composed of five members of the Board of Directors is set up in line with the Luxembourg law on the audit profession. The Audit Committee oversees the financial reporting, internal control, risk management, internal and external audit of the EFSF.
- The annual accounts are audited by a private external auditor registered with the Luxembourg audit supervisor (*Commission de Surveillance du Secteur Financier*)
- Shareholders' Annual General Meeting serves to discharge the accounts.

ESM Board of Auditors: Reports

- **Audit Reports** to the ESM Management presenting the findings and recommendations from the Board of Auditors' independent audits

- **Report in respect of the ESM financial statements**
 - Contained in the ESM Annual Report and available to the general public
 - In addition to the audit opinion by the external auditor

- **Annual Report to the Board of Governors**
 - Presented in the Board of Governors' annual meeting (together with the ESM management comments)
 - Circulated to the national parliaments and SAI of all ESM Members
 - Circulated to the ECA and the European Parliament

Additionally, the Board of Auditors may inform the Board of Directors at any time of its findings.

Why is the ESM important and the future

- Permanent IFI to ensure market confidence and prevent future crises in the euro area
- Very strong track record over the last couple of years
 - Massive lending without cost for the taxpayer has kept the euro area intact
 - This has promoted reforms and debt sustainability
 - Reduced the demands on the ECB to do more
- Banking Union: current tools and new instrument
 - Macro-economic adjustment lending, with a banking component
 - Bank recapitalisation through loans to governments, like Spain
 - Direct Recapitalisation Instrument: up to €60 bn., as a last line of defence when the bank is deemed to be viable but the home country cannot afford to support it
- Europe's focus is on regaining competitiveness and growth
- Integration in Europe

