

## European Stability Mechanism

### Investment Policy

#### *Preface*

The Treaty establishing the European Stability Mechanism (hereafter “Treaty”) stipulates in Article 3 that the “*purpose of the ESM shall be to mobilise funding and provide stability support under strict conditionality, appropriate to the financial assistance instrument chosen, to the benefit of ESM Members which are experiencing, or are threatened by, severe financing problems, if indispensable to safeguard the financial stability of the euro area as a whole and of its Member States.*”

The definition of the Investment Policy shall contribute towards the credibility and effectiveness of the ESM, and it shall be implemented in a prudent manner and contribute towards an efficient and flexible portfolio management. In particular the investment of the proceeds of the paid-in capital and the reserve fund (hereafter “Investment Portfolios”) forms the core of the investment activities of the ESM and shall contribute towards the creditworthiness of the ESM.

The provisions on the capital of the ESM are laid down in Chapter 3 of the Treaty. The initial aggregate nominal value of paid-in shares shall be EUR 80 000 million. The main objective of Investment Portfolios is to ensure that the maximum lending volume is always readily available, and to absorb potential losses. The reserve fund of the ESM is defined in the Article 24 of the Treaty.

The ESM Investment Policy is approved by the Board of Directors and defines the framework for ESM to carry out its investment management.

The Managing Director is responsible for implementing a prudent investment policy for the ESM, and for setting up the appropriate governance framework to meet this objective.

#### *Article 1*

##### *Investment objectives*

###### 1. Liquidity of Investment Portfolios

The Investment Portfolios shall be used in line with Article 25 of the Treaty to cover losses arising in ESM operations, and specifically any shortfall due to a non-payment by a beneficiary ESM Member. When the emergency procedure referred to in Article 4(4) of the Treaty is used, a transfer from the reserve fund and/or the paid-in capital to an emergency reserve fund is made in order to constitute a dedicated buffer to cover the risks arising from the financial support granted under that emergency procedure.

###### 2. Constant availability of ESM’s maximum lending volume

The risk appetite for the investment of the Investment Portfolios shall be defined in accordance with ‘The High Level Principles for Risk Management’. The Investment Policy of ESM must ensure that the Investment Portfolios’ market value exceeds a threshold of 15% in relation to the

targeted maximum lending volume of ESM for a high level of confidence, such targeted maximum lending volume being defined as the maximum lending volume, adjusted during the initial period of capital payment by the portion of installed paid-in capital in the initial paid-in capital. An appropriate diversification of investments shall be used to reduce the volatility of the aggregate market value of the portfolio.

### 3.ESM's creditworthiness

The investment of the Investment Portfolios shall in line with Article 22 of the Treaty follow a prudent Investment Policy, in order to preserve ESM highest creditworthiness. To achieve this, an amount equivalent to 15% of the targeted maximum lending volume of ESM at the time shall be invested in assets of the highest creditworthiness, as defined in the `General Eligible Asset List` (Annex 1). The remaining part of the Investment Portfolios shall be invested along the `Enlarged Eligible Asset List` (Annex 2), provided that for the Investment Policy the overall ESM exposure to each issuer has been taken into account in order to avoid concentration risk.

### 4.Return

In line with Article 22 of the Treaty, the ESM shall be entitled to use part of the return on its Investment Portfolios to cover its operating and administrative costs. In line with Article 23 of the Treaty and the dividend policy, investment return can be retained as reserves or distributed as a dividend to the ESM Members *"if the amount of paid-in capital and the reserve fund exceeds the level required to maintain the lending capacity of the ESM and proceeds from the investment are not required to avoid a payment shortfall to creditors"*.

## ***Article 2***

### ***Investment principles***

- 1.All transactions related to the investment of the proceeds of the paid-in capital and reserve fund shall be conducted in a prudent manner in order to ensure ESM's creditworthiness as well as to limit any effects on market prices, even in situations of market stress.
- 2.All transactions related to the proceeds of the paid-in capital and reserve fund shall be conducted only with eligible counterparties.
- 3.An appropriate level of diversification of the Investment Portfolios shall be maintained in order to reduce the ESM's overall risk. Diversification shall be attained through allocation between various asset classes, geographical areas (and notably supranational institutions, and issuers outside of the Euro Area), issuers and instruments.
- 4.Derivatives shall be used for risk management purposes only.
- 5.Any currency risk shall be hedged into Euro to ensure a limited remaining foreign exchange risk for the ESM. As a main investment strategy, assets, issued by Euro Area or non-Euro Area entities, denominated in Euro shall however be favored over assets denominated in a foreign currency.
- 6.The implementation of the Investment Policy guidelines for ESM Investment Portfolios on a daily basis shall be governed through Operating Manuals, as described in Article 6. An appropriate

governance framework, risk indicators and benchmarks shall be precisely defined to ensure the fulfillment of the investment objectives, and to allow the Board of Directors to monitor the management of the investment portfolios.

### *Article 3*

#### *Eligible instruments*

1. Within a strict credit risk framework, the asset classes eligible under the Investment Policy for the ESM Investment Portfolios shall be exclusively based on the following criteria depending on the nature of the Investment objectives:
  - a. Ability of the ESM to cover losses arising in the ESM operations, maintain the constant availability of the targeted maximum lending volume and maintain the highest financial strength of the ESM: 'General Eligible Assets List' (Annex 1);
  - b. Enhancement of diversification and return: 'Enlarged Eligible Assets List' (Annex 2).
2. In case any asset loses its eligibility, the Managing Director, in accordance with the Board of Directors, may decide to reduce the exposure of this given asset, but doing so within an appropriate timeframe and manner in order to minimise any impact on market prices.

### *Article 4*

#### *Portfolio Structure*

1. In accordance with Article 25 of the Treaty, losses arising from ESM operations shall be firstly deducted from the reserve fund. Therefore the resources of reserve fund shall be invested in order to fulfill the high liquidity requirement of this objective.
2. The Investment objectives, defined earlier (see Article 1), shall be implemented by segregating the ESM Investment Portfolios into separate portfolios (investment tranches). The characteristics and relative size of each tranche are described below.
3. The tranche with the highest requirements on liquidity of investments is the **Short-term tranche**:
  - a. The main objective of the Short-term tranche is to allow the ESM to face any temporary disbursement to cover any shortfall due to a non-payment by a beneficiary country.
  - b. The target size of this tranche shall be determined in line with the future payments due from the beneficiary countries over at least 6 months, with a minimum overall size of EUR 5 000 million.
  - c. This tranche is invested in liquid investment instruments with a capital preservation objective at a one-year horizon, for a high level of confidence.
  - d. Assets of the Short-term tranche shall be compliant with the General Eligible Assets List and shall be appropriately diversified. For diversification purposes, at least 30% of this amount shall be invested either in supranational institutions or outside the Euro

Area and no sovereign exposure shall represent more than its capital key as defined by the Treaty.

e. The proceeds of the reserve fund shall be invested in full in the Short-term tranche.

4. The tranche to assure diversification, and financial strength is the **Medium/Long-term tranche**:

a. The Medium/Long-term tranche shall have the main objective of ensuring the financial strength of the ESM. This tranche shall be managed to enhance the return of the Investment Portfolios subject to the constraints specified in the Investment objectives as well as the asset eligibility criteria. This tranche is also mainly invested in liquid investment instruments, and could also be monetized.

b. The size of the Medium/Long-term tranche is the remaining amount of the Investment Portfolios after the constitution of the Short-term tranche.

c. The tranche shall be invested with a capital preservation objective at a three-year horizon, and a maximum loss of 2% at a one-year horizon, for a high level of confidence. This strict market risk policy should allow the Investment Portfolios market value to fulfill the requirement of the 15% threshold compared to the targeted maximum lending volume of ESM at the time, as defined in Article 1(2).

d. To ensure the financial strength of the ESM, a minimum share of the Medium/Long Term Tranche shall be compliant with the General Eligible Assets List. As defined in Article 1(3), this minimum share shall ensure that an amount equivalent to 15% of the targeted maximum lending volume of ESM at the time is invested in the General Eligible Assets List. For the amount exceeding the threshold of 15% of the targeted maximum lending volume, the Enlarged Eligible Assets List applies.

e. For diversification purposes, at least 30% of the Medium/Long Term Tranche, complying with the General Eligible Assets List or the Enlarged Eligible Assets List, shall be invested either in supranational institutions or outside the Euro Area and no sovereign exposure shall represent more than its capital key as defined by the Treaty.

5. The Managing Director periodically determines the respective appropriate size for the Short-term and Medium/Long term Tranches in accordance with the ESM Investment Policy Guidelines.

## ***Article 5***

### ***Management of the liquidity of ESM balance sheet***

1. In order to enable ESM to face any due payments arising from its liabilities in the next 12 months, if not already covered by the Available Funds, such Available Funds being the aggregate of the Short-Term Tranche and 50% of the Medium/Long Term Tranche invested in the General Eligible Assets, the difference between the Available Funds and the due payments arising from ESM liabilities in the next 12 months shall be prefunded. The prefunding of the needs shall be invested in a Liquidity Buffer.

2. The liquidity Buffer's Investment rules shall be identical to those applying to the Short Term Tranche.

## ***Article 6***

### ***Implementation***

1. In line with Article 22 of the Treaty, the Managing Director is responsible for the implementation of the Investment Policy. It is his responsibility to:
  - a. Organise periodic reviews of the ESM Investment Policy Guidelines for the Board of Directors, and of the results of the implementation of the Investment Policy.
  - b. Define the appropriate Governance framework, including the relevant Committees (such as an Investment Committee, and Risk Committee) and the relevant Documentation (such as a Manual for the Code of Conduct, and the Manual for the Investment Implementation Governance), known as the Operating Manuals.
  - c. Implement the Investment policy based on relevant risk indicators and benchmarks, as defined in the Manual for Investment Strategy, for the above mentioned portfolios, and the active risk budget.
2. More specifically, the Managing Director shall ensure a smooth implementation of the ESM Investment Policy guidelines, once paid-in capital has been paid. As an immediate investment of the capital payments along the targeted Investment Policy might lead to market price impacts, some temporary divergence, namely a higher share in short term and very liquid assets, shall be tolerated.

## Annex 1

### General Eligible Assets List

Investment Instruments	<ul style="list-style-type: none"><li>• Debt securities (mainly bonds, bills, covered bonds and commercial papers, certificates of deposit)</li><li>• Secured deposits with eligible counterparties (repurchase agreements where ESM receive securities collateral as a guarantee of a placement)</li><li>• Unsecured deposits with eligible counterparties (placement in money market instruments with no collateral)</li></ul>
Issuer	<ul style="list-style-type: none"><li>• Central Banks</li><li>• Sovereigns and their related debt management offices</li><li>• Euro Area Government related agencies</li><li>• Supranational institutions</li></ul>
Rating criteria	<p>Minimum rating for all Debt securities:</p> <p>For each rating agency, a short- or long-term rating which is equal to or higher than at least AA or equivalent for short-term assets</p>

## Annex 2

### Enlarged Eligible Assets List

Investment Instruments	<ul style="list-style-type: none"><li>• Debt securities (mainly bonds, bills, covered bonds and commercial papers, certificates of deposit)</li><li>• Secured deposits with eligible counterparties (repurchase agreements where ESM receive securities collateral as a guarantee of a placement)</li><li>• Unsecured deposits with eligible counterparties (placement in money market instruments with no collateral)</li></ul>
Issuer	<ul style="list-style-type: none"><li>• Central Banks</li><li>• Sovereigns and their related debt management offices</li><li>• Government related agencies</li><li>• Supranational institutions</li><li>• Financial Institutions</li></ul>
Rating criteria	<ul style="list-style-type: none"><li>• Minimum rating for all Debt securities issued outside the Euro Area, or by non-Sovereign entities:  For each rating agency, a short- or long-term rating which is equal to or higher than at least AA or equivalent for short-term assets</li></ul>