2014
ANNUAL REPORT

EUROPEAN STABILITY MECHANISM

European Stability Mechanism
esm

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Spotlight

Throughout the report, we have spotlighted the views of each of the Finance Ministers of the euro area Member States. These quotes relate to the ESM and its role, not to the text of the pages on which they appear.

INTRODUCTION TO THE ESM

The European Stability Mechanism (ESM) is a permanent crisis resolution mechanism established by the euro area countries. The ESM's mission is to provide financial assistance to ESM Members experiencing or threatened by severe financing problems to safeguard the financial stability of the euro area as a whole and of its Members.

The Luxembourg-based ESM raises funds by issuing debt instruments, which are purchased by institutional investors. The proceeds enable the intergovernmental institution, in operation since 8 October 2012, to provide its Members the following types of financial assistance:

- loans to cover their financing needs;
- loans and direct equity injections to recapitalise financial institutions;
- credit lines to be used as precautionary financial assistance;
- primary and secondary debt market purchases of Member States' national bonds.

ESM financial assistance is linked to beneficiary Member States addressing weaknesses in their economies through reforms which are jointly agreed by that Member, the European Commission, in liaison with the European Central Bank and, where applicable, the International Monetary Fund.

More information about the ESM can be found on our website: **www.esm.europa.eu.**

Note: The 2014 ESM Annual Report contains the Financial Statements for the financial year ending 31 December 2014, together with the report of the external auditors in respect of their audit concerning these Financial Statements, and a report of the Board of Auditors in respect of these financial statements.
The description of the policies and activities of the ESM includes certain information available as of 20 May 2015 but all historic financial data is limited to the period up to 31 March 2015.

Klaus Regling
Managing Director
European Stability Mechanism

Message from the Managing Director

The euro area as a whole put the crisis largely behind it in 2014. Positive developments were particularly marked in Cyprus, Ireland, Portugal, Spain and – at least until autumn 2014 – in Greece, the five euro area countries that have benefitted from financial assistance in a European Stability Mechanism (ESM) or a European Financial Stability Facility (EFSF) programme. Between December 2013 and May 2014, Spain, Ireland, and Portugal successfully exited their programmes and regained the investor confidence that they had lost. Greece was able to tap the bond market in mid-2014. But problems remain, with concerns particularly focused on Greece. Despite achievements early in the year – an improving economic performance and policy reforms adopted – by autumn, Greece had lost cautious recognition from financial market participants. It must now find a credible way forward to restore market trust. Overall, however, the euro area prepared the ground for sustainable growth in the future.

The ESM and EFSF approach prompted remarkable improvements in the programme countries: both institutions provide loans at very favourable conditions to countries that are no longer able to finance themselves on the markets at reasonable rates. The assistance is, however, conditioned on strict reform implementation. To receive the advantageous ESM and EFSF loans, beneficiary countries must make their economies competitive, consolidate budgets, and stabilise financial sectors.

Independent international assessments confirm that this strategy is working. According to the Organisation for Economic Co-operation and Development's *Going for Growth* report, Greece, Ireland, Portugal and Spain were four of the top five most reform-minded countries in the entire OECD area in 2014. The World Bank's *Doing Business Survey* showed that Greece had made the biggest leap forward in 2014 among all the countries examined in a ranking that measures the ease of starting and operating a local business. Provided

the reform momentum is sustained, the former crisis countries are thus likely to become reform champions with excellent economic prospects.

The favourable ESM and EFSF lending conditions are an impressive act of solidarity among euro area Member States. The combination of loans at very low interest rates and with unusually long maturities ensures significant annual budgetary savings for all the programme countries. Thanks to these ESM and EFSF programmes, the other euro area Member States can show solidarity towards the beneficiary countries without any direct cost to their taxpayers.

The ESM and EFSF help the beneficiary countries to improve their ability to service their debt. The ESM shareholders, for example, twice accepted Spain's voluntary early repayment of its loan without burdening the country with any significant cost. In a similar spirit of long-term partnership, the EFSF shareholders accepted Ireland's and Portugal's decisions to reduce their debt burden by repaying parts of their more onerous International Monetary Fund (IMF) loans early. The EFSF shareholders could have asked for a simultaneous early repayment of the EFSF loan, which has much more advantageous terms, from both countries. It refrained from doing so, however, in order to continue to support them, thus strengthening their debt sustainability.

Despite uncertainties about Greece, the euro area has become a stable and much better functioning currency union. Lithuania underlined its attractiveness by joining monetary union in 2015 as the 19th country to adopt the euro. As a result, Lithuania also became the 19th Member of the ESM. Since the establishment of the ESM in October 2012, the Baltic state has become the second new Member to join, following neighbour Latvia in 2014.

The euro area's improved fitness stems from determined reform implementation in the programme countries, better economic and fiscal policy coordination at the European level, a robust monetary policy response to falling inflation, and a stronger banking system. The establishment of the Banking Union with a European supervision of systemic banks under the auspices of the European Central Bank (ECB) strengthened the euro area's foundations.

The crisis both exposed the institutional weaknesses of the original Economic and Monetary Union and prompted policy makers to remedy them. In a particularly important step, they established the ESM as the euro area's permanent crisis resolution mechanism. It has a maximum lending capacity of €500 billion, more than €450 billion of which is still available.

One of the building blocks of Banking Union is the ESM Direct Bank Recapitalisation Instrument for euro area financial institutions. Since its adoption in December 2014, the ESM can recapitalise systemic and viable banks directly as a last resort measure based on a unanimous decision among euro area Member States. Under specific circumstances, the ESM could use this instrument with up to €60 billion to safeguard financial stability in the currency union and to contribute to severing the vicious feedback-loop between sovereign debt and the banking sector.

The ESM and EFSF can only grant loans to euro area Member States in a crisis if the two institutions have raised the money previously on the markets. In 2014, as in 2013, the two institutions combined were the fifth largest issuer of euro bills and bonds in the euro area after Germany, France, Italy, and Spain. Although the issuing volumes will decrease, the ESM and EFSF will remain within the ranks of significant euro area issuers for a long time.

The ESM and EFSF are long-term partners of the programme countries. With the unusually long maturities of our loans at very low interest rates we will accompany them for decades to come. In the context of the Early Warning System, the ESM's shareholders have tasked it with monitoring its debtors' ability to reimburse ESM loans until they have been fully repaid. As the largest or one of the largest creditors of the programme countries our interests are aligned with theirs. Just like the programme countries we are looking for sustainable economic development that allows for long-term success so that we can be confident that the ESM will be repaid in full.

While progress at the national and European level has reduced the vulnerability and increased the robustness of the currency union, there is still a need to improve the euro area's governance further. To drive this process forward, the Heads of State and Government have tasked the Presidents of the Commission, the European Council, the ECB, and the Eurogroup to put forward proposals. As the sole institution dedicated to the euro area alone, the ESM fully supports this initiative to make the monetary union more resilient.

Letter of Transmittal to the Board of Governors

18 June 2015

Dear Chairperson,

I have the honour to present to the Board of Governors the Annual Report in respect of the financial year 2014, in accordance with Article 23 (2) of the By-Laws of the European Stability Mechanism (By-Laws).

The Annual Report includes a description of the policies and activities of the European Stability Mechanism (ESM) during 2014. It also contains the audited Financial Statements as at 31 December 2014, as drawn up by the Board of Directors on 25 March 2015 pursuant to Article 21 of the By-Laws which are presented in Chapter IV. Furthermore, the report of the external auditor on the Financial Statements is presented in Chapter V and the report of the Board of Auditors on the Financial Statements in Chapter VI. The independent external audit was monitored and reviewed by the Board of Auditors as required by Article 24 (4) of the By-Laws.

Klaus Regling
Managing Director

01.

ECONOMIC DEVELOPMENTS

What have we learned from the euro area crisis?

Today, the worst of the crisis is over and Europe is making its way along a slow, yet sustainable, path to recovery. This is a good time to reflect on what lessons can be drawn from the crisis, to understand whether the economic policies deployed are enough to prevent future crises.

The great European recession revealed economic and financial vulnerabilities and institutional weaknesses in the monetary union's design. National and European policy makers reacted to the erupting crisis by rapidly devising solutions. When rescue measures failed to achieve the desired result, policy makers fine-tuned and complemented them, eventually reversing market sentiment and starting the recovery. As we reach the middle of 2015, the recovery, which still needs to gain pace, faces downside risks, mostly geopolitical. In addition, Europe must address the crisis' remaining fallout, especially the high unemployment rates a number of countries face.

Still, with the worst behind it, now is a good point for Europe to take stock of the lessons learned and consider the next steps to build a yet more robust monetary union able to withstand future shocks.

KEEPING COMPETITIVENESS ALIGNED

A crucial lesson from the crisis is that countries in a monetary union cannot sustain large divergences in competitiveness over an extended period. As the development of unit labour costs in the five countries that later entered into an EFSF or an ESM programme shows, costs rose significantly in comparison to the rest of the euro area. This resulted in a significant loss of competitiveness in the programme countries that translated into large current account deficits and an increasingly negative international investment position. This needed to be reversed, either on the back of macroeconomic reforms linked to financial assistance programmes or, as in the case of Spain, through a reform agenda developed independently to tackle past imbalances.

In economies outside a monetary union, exchange rate adjustments can resolve these misalignments. In the euro area, such an adjustment had to be achieved in part domestically through socially and politically painful expenditure cutting. Opening and liberalising product and labour markets to increase and improve labour productivity has proven to be key. Indeed, the countries with programmes in place have implemented substantial reforms. In its *Going for Growth* survey, the Organisation for Economic Co-operation and Development (OECD) ranks the reform efforts of its 34 member states. Among the top five countries, four underwent an EFSF or ESM programme. The crisis experience has amply demonstrated that a comprehensive reform of product and labour markets supports investment and exports, and therefore facilitates rebalancing and growth.

Pursuing structural reforms is a difficult process, as governments need to take on vested interests. The European experience also shows that internal adjustments through wage and price corrections are feasible, contrary to what many observers argued at the time. All countries under EFSF and ESM programmes have dramatically reversed the previous trend of decreasing competitiveness and are closing the gap vis-à-vis core countries.

ENSURING PRUDENT FISCAL POLICY IN GOOD TIMES

Another important lesson concerns fiscal policy. The crisis underscored the need to pay sufficient ongoing attention to the sustainability of public finances, even as economies are growing strongly. When the crisis worsened, the market had already discounted earlier consolidation efforts as insufficient, with a resulting and instantaneous widening in market interest rate spreads to those of core country debt. Although Greece faced the most severe fiscal problems, all programme countries reined in public spending, changed tax legislation, and tightened administrative procedures to increase revenues. Thus, sound fiscal policies and constant budgetary development monitoring are fundamental, especially during the expansionary part of the cycle.

A corollary from the previous two lessons is that prudent fiscal policy and structural reforms are complementary. In the face of fears of low future growth, so-called secular stagnation, budgetary sustainability will result in higher and more stable long-run growth only if accompanied by structural reforms.

DEEPENING EUROPEAN GOVERNANCE

The crisis revealed that euro area economic governance was not strong enough, particularly for crisis

Jeroen Dijsselbloem
The Netherlands

As the Chairman of the Board of Governors I can confidently say that the ESM has become an effective crisis resolution mechanism and I am convinced that the ESM will play an important role in the financial stability of the euro area in the years to come.

prevention and financial crisis management. As an example, it became evident early on in the crisis that Greek fiscal statistics were not reliable. Member States reacted by increasing Eurostat's powers to scrutinise national statistics. More broadly, they found it necessary to create stricter debt and deficit rules, curb the room for political interference, and, in the absence of joint decision making, introduce balanced budget rules in the national legal systems. These procedures, designed to correct macroeconomic imbalances, also significantly improved economic policy coordination in the currency union.

All in all, the euro area leaders treated the crisis as an opportunity to take a quantum leap in European integration. They strengthened the fiscal rules, initiated surveillance of macroeconomic imbalances, and established advance coordination of economic policy through the 'European Semester'. These changes allow for a comprehensive crisis response without altering the EU Treaties. With them, Europe embarks on a new model of economic governance characterised by better policy coordination.

CREATING A LENDER OF LAST RESORT FOR CRISIS RESOLUTION

Another important lesson from the crisis concerns the lack of a lender of last resort for governments within monetary union. When the euro area was set up, it was taken for granted that Member States would not lose market access or investor confidence and, thus, the ability to roll over maturing debt and finance additional fiscal expenditures at sustainable rates. The fiscal framework was seen as sufficiently strong to prevent such situations.

While the ECB played a very active role during the crisis, and stepped in through several targeted policy initiatives, it could not take on the role of a lender of last resort for governments. According to the EU Treaties, the ECB is not allowed to engage in monetary financing of state budgets. This is a crucial ingredient to preserve independent central bank action, maintain low inflation in the monetary union, and pre-empt excessive fiscal largesse. Therefore, a new institution had to play this role. Here as well, the leaders learned by doing, and improved upon their initial urgent response by creating, first, the EFSF as a temporary crisis resolution mechanism and, subsequently, the ESM as a permanent institution.

At first, the EFSF and ESM lending toolbox mirrored that of the IMF and the EC. By drawing ongoing lessons from the evolving crisis, the EFSF and ESM redefined their lending terms and approach, leading to a new paradigm of sovereign lending. They dropped the initial framework, which included a high margin, because it undermined sustainability and market access. The political costs turned out to effectively deter the 'moral hazard' problem. Financing costs fell to very low levels. Maturities became very long, stretching from an average of 12.5 years for the Spanish facility to more than

32 years for the Greek one. (The boxes on the 'Impact of EFSF lending on bond markets' and on 'How Greece benefitted from debt relief' explain these financing conditions in more detail.) This new approach eased the programme countries' fiscal burden and facilitated their renewed market access at affordable costs. EFSF lending terms helped programme countries reduce uncertainty, enabling them to regain access to capital markets. Today, with over €450 billion available for support, the ESM continues to help sustain the confidence of investors and credit agencies, contributing to the stability of the sovereign bond markets.

Looking back, the EFSF and ESM firewall turned out to be indispensable to overcoming the crisis. By end-2014, €233 billion had been disbursed to five countries in under four years. This is three times as much as the IMF disbursed globally in the same period. Without the EFSF and the ESM, some euro area Member States would today likely no longer be part of the monetary union. Their departure would not only have posed a huge risk with enormous potential cost for the country concerned, it would also have changed the Europe that we know.

FORTIFYING THE FINANCIAL SYSTEM

Already at a fairly early stage of the crisis, European policy makers recognised the insufficiency of existing supervision to stem systemic crises and the need to create common supervision standards across Europe and financial industries. Policy makers created new European supervisory authorities for banks, insurance companies, capital market instruments, and rating agencies. The European Banking Authority drew up a 'single rule-book' for European banks, aiming to make the banking system safer. The European Systemic Risk Board was put in place to monitor macroprudential risks.

Despite these earlier efforts, lending rates across countries remained disparate and monetary policy easing was not effectively transposed into better lending conditions and credit. Further policy action was needed, in particular a more comprehensive approach which ultimately resulted in the multi-layered Banking Union project.

A European supervisory and resolution structure was adopted. The Single Supervisory Mechanism (SSM) can thoroughly supervise banks operating cross-border in Europe. To assess their strength, the SSM conducted an initial balance sheet assessment of all the 130 biggest banks it supervises. The banks passed the assessment with limited additional capital requirements.

Moreover, policy makers recognised that banks had to become better capitalised. The EC estimates that, between 2008 and 2014, overall bank capital increased by €560 billion, using primarily private but also public capital.

At the same time, the impact of the direct and indirect costs of the bank rescues on European taxpayers forced a change of paradigm in bank resolution. In one of the crisis' most visible lessons, it became clear that future public sector involvement needed to be capped. Instead, authorities had to create a system under which bank creditors would systematically share this burden. The so-called 'bail-in' of the private sector in these operations increasingly became the approach used to share losses caused by bank failure. Authorities have already used bail-ins several times, sparing public resources in bank recapitalisation or resolution plans. Bail-ins provide greater market discipline and force investors to scrutinise their decisions more. In addition, the Single Resolution Mechanism (SRM) started its work. Depending on the entry into force of the intergovernmental Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund (SRF), the SRM is expected to be in full force as of 1 January 2016, when the SRF and the new bail-in regime become fully applicable. Together, the SSM and the SRM can address problems emerging in the banking system efficiently and comprehensively. They will become the backbone of a more integrated post-crisis European banking market and contribute to a better functioning monetary union.

DETERMINING THE NEXT STEPS

A policy response to a crisis is often not the result of standard decision-making procedures. Policy makers need to take short-term decisions under intense pressure. Their challenge was to frame the immediate crisis response within a wider far-reaching reform process, which should outlive this crisis and help prevent the next.

In the end, the policy strategy devised to address the crisis has proven effective.

It employed structural reforms and growth-enhancing measures to reduce macroeconomic vulnerabilities. Additionally, measures to strengthen the resilience of the banking sector took effect and will create a more solid and better-integrated European financial system. Important reforms to reinforce euro area economic governance were adopted, including strengthening the fiscal framework and extending surveillance to macroeconomic imbalances. Last but not least, policy makers deployed crisis resolution support to ease economic hardship. Overall, Europe not only successfully addressed the crisis, it also enhanced policy coordination in ways not considered possible before.

In addition, European policy makers provided significant resources to support investment in long-term growth. Most recently, the EC launched the 'Juncker plan'. Jointly with the European Investment Bank (EIB), the EC aims to facilitate more than €300 billion in new investment, and propose policy reforms to overcome

Johan Van Overtveldt
Belgium

For the economic recovery to be strong and sustainable, confidence is the overwhelming determining factor. For confidence to gain traction within the euro zone, a well-performing ESM is of the highest necessity.

investment barriers. Still, a number of challenges for sustained growth lie ahead. Reducing high debt levels in the public and private sector and addressing the effects of an ageing population, likely to constrain growth, will remain key challenges to be dealt with in the coming years. Building a resilient European financial system, able to provide growth financing, will require further policy action.

The upcoming Four Presidents Report[1] will discuss the next steps to improve growth prospects and enhance the euro area's resilience, making proposals to the Heads of State or Government. The ESM, as the sole euro area institution, will make a contribution to the subsequent debate.

Europe has come a long way, and monetary union is now more robust and resilient to external shocks. But not all the lessons of the crisis have yet been fully addressed. A number of challenges for sustained growth lie ahead: responding to ageing populations, unwinding high debt levels, and implementing economic reforms to improve low growth prospects. In the short run, geopolitical factors, frictions in the euro area and economic changes can lead to economic and financial volatility. There is thus scope for the euro area to further strengthen its resilience.

Europe cannot wait for the next crisis to discover, again, how it should have been better prepared.

1 The Four Presidents' report on Economic and Monetary Union is being prepared by the Presidents of the European Council, the European Commission, the European Central Bank and the Eurogroup for the June 2015 European Council.

CURRENT EURO AREA POLICY TOOLBOX WOULD HAVE MADE CRISIS MILDER

The recent improvements in euro area governance, if agreed and implemented before 2007, would not have prevented the global financial crisis, but they would have reduced home-made vulnerabilities and rung the alarm bells much sooner. The following list of crisis-prompted changes explains how their earlier adoption would have made the crisis milder and shorter.

- The rising Greek budget deficit, which ultimately reached 15.6%, would have been detected much earlier had **Eurostat**'s powers been strengthened sooner, entitling it to examine Member States' public accounts.

- The real estate bubbles in Ireland and Spain might have been detected earlier, had the new **European Systemic Risk Board** already existed. It could have provided the relevant authorities with recommendations for early corrective action.

- The large current account imbalances that emerged in the middle of the last decade would have been identified earlier, had the new **Excessive Imbalances Procedure** already been introduced.

- Financial assistance would have reached beneficiary Member States faster, had the **EFSF** and **ESM** existed earlier. Investors would then have considered the crisis response more credible, dissuading some from short-selling and tempering the resulting turmoil.

- The problems in certain large institutions, particularly in Ireland and Cyprus, could have been tackled sooner, had **Banking Union** already been in place. It would also have improved crisis coordination. The new bail-in rules of the Bank Recovery and Resolution Directive would have protected public accounts better.

- The fiscal rules could have been enforced more effectively in all Member States, had the **Stability and Growth Pact** been reformed earlier. This would have sent a more decisive signal about their strictness.

Despite the reforms the euro area will continue to be affected by external shocks and potential policy missteps, but the reforms could have shortened and moderated the crisis that the euro area experienced.

IMPACT OF EFSF LENDING ON BOND MARKETS

Since the outbreak of the global financial crisis, fiscal and monetary authorities have employed a wide range of policies to overcome it. Central banks embarked on quantitative easing exercises, while fiscal accommodation helped sustain activity and refloat banks' balance sheets. In the euro area, Member States themselves made considerable fiscal efforts, while the area and the EU as a whole provided significant funds as fiscal assistance via the EFSF, the European Financial Stabilisation Mechanism, and the ESM.

To make sense of these measures, central banks and fiscal authorities have analysed their effects, helping policy makers understand whether the various policies adopted worked or not. Remarkably, there has been no systematic analysis to date of the impact of EFSF financing on the affected economies. The structure and condition of EFSF loans underwent various changes over time, with maturities extended and margins reduced in an attempt to help relieve the beneficiary Member State's debt servicing burden. This analysis focuses on Ireland and Portugal and excludes Greece, whose original programme did not include the EFSF. The progressive changes undertaken modified the countries' debt servicing profiles, helping improve market access for both Ireland and Portugal and reducing sustainability concerns.

EVOLVING TERMS AND CONDITIONS OF EFSF LOANS TO IRELAND AND PORTUGAL

In December 2010, Ireland agreed a financial package of €85 billion, made up of €17.5 billion in own resources and €67.5 billion in external resources. The EFSF provided €17.7 billion. Originally, the EFSF loan to Ireland carried a margin of 247 basis points over the EFSF's funding costs with a maximum average maturity of 7.5 years. Subsequently, the loan underwent a series of incremental changes. In July 2011, it was agreed that Ireland would benefit from a reduction of the loan's margin to 0 and an extension of the average maturity to 15 years. Some two years later, Member States agreed to lengthen the weighted average maturity further, to up to 22 years from 15. These measures aimed at supporting Ireland's efforts to regain full market access. Portugal in turn entered its EFSF programme in May 2011. The size of the financial assistance package was €78 billion, of which the EFSF disbursed €26 billion. At the programme's outset, Portugal agreed to pay a margin of 208 basis points, with a maximum average maturity of 7.5 years. In parallel with the decisions on Ireland, Members decided to align Portugal's loan conditions with those already granted to Ireland. The maturity was extended to 15 years and the margin reduced to 0 basis points. Finally, Portugal received an additional seven-year maturity extension, of up to 22 years, in March 2013, also in line with Ireland.

EFFECTING CHANGE: A CASE-STUDY OF THE IMPACT OF EFSF LOAN TERMS ON BOND MARKETS

To study, in an informative and simple way, whether the various changes to the conditions of the EFSF loans to Ireland and Portugal had a meaningful impact on debt markets, the analysis compares the behaviour of various debt market indicators, before and after the announcement of the changes in the terms and conditions of the loans.[2] More specifically, it looks at the effect on secondary markets, focusing on the secondary market for sovereign debt, and assesses the dynamics of yields and market liquidity as measured by the bid-ask spreads. Given that maturity extensions work by shifting repayments into the future, thus opening a window of opportunity for market financing, the effect of the extension should differ across maturities. This analysis considers the behaviour of 3-, 5- and 10-year maturities to check whether this is the case.

To illustrate the yield curve changes following the contract amendments, Figure 1 displays the yield curve dynamics around the set of loan changes. Figure 2 shows the changes in market liquidity, reflected in the movements of the bid-ask spreads three months after the announcement. Again, the information is presented by maturity. Before the July 2011 maturity extension and margin reduction, Ireland was facing substantial stress, with the yield curve inverted and 3-year yields averaging 16.47%. The upper-left panel in Figure 1 shows that the change announcement had a strong and long-lasting positive effect on the yield curve's evolution. After just one month, all yields had fallen. After three months, all yields had declined even further and the yield curve had flattened. In another sign of the loan amendments' beneficial effect, the bid-ask spreads at all maturities narrowed after the change (Figure 2). As with yields, the largest drops occurred in the 3- and 5- year maturities. In theory, the relief should have been felt most at those maturities, given that the 7.5-year extension's aim was to provide cash flow relief beyond that period. The maturities benefiting most were, indeed, those below the 7-year threshold, indicating that the measure delivered the expected benefits.

2 There is an important caveat to this approach. One has to control for other shocks that occur simultaneously and could also explain the observed dynamics. None of the ECB operations took place at the same time as the changes on the EFSF loans.

Figure 1. Yield curve dynamics around loan changes

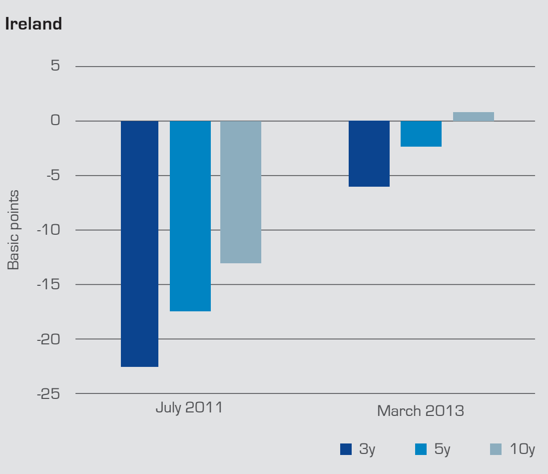
Note: Each graph corresponds to the behaviour of the yield curve after specific changes. The July 2011 changes correspond to a maturity extension and an interest rate reduction. The March 2013 changes correspond to a maturity extension.

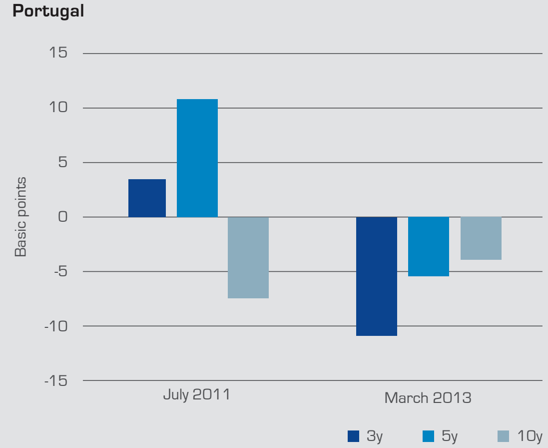
Source: Bloomberg

Finally, in March 2013, when the second maturity extension was approved, Ireland was already enjoying significantly lower yields. Still, following the announcement, yields on the 3- and 10-year fell further (lower-left panel in Figure 1). Bid-ask spreads barely changed, reflecting the successful normalisation of the Irish bond market.

Similarly, by the time of the first loan modification in July 2011, Portuguese yields had risen (16.46% on the 3-year). As the upper-right panel on Figure 1 shows, following the announcement of the loan changes, the yield curve shifted down, especially in the shorter maturity. While the improvement partly reversed in the subsequent two months, these dynamics confirm that,

Figure 2. Changes in bid-ask spreads following the loan amendments





Source: Bloomberg

as in the Irish case, the maturity extension provided a temporary period of reduced sustainability concerns. Reflecting the limited effect of this first contract amendment, the bid-ask spreads failed to react positively to the announcement (Figure 2). At the time of the last maturity extension in March 2013, Portugal was already facing lower yields, thanks to its good performance under the programme and the ECB's policy measures. While immediately after the announcement only the 3-year yield fell, after three months, the entire yield curve was well below the pre-announcement level (Figure 1, lower-right panel). Moreover, bid-ask spreads narrowed by about one third of their pre-announcement value, further evidence of the secondary market's return to normal (Figure 2).

The benefits of the maturity extensions also translated into improved rating agency assessments. The 2013 announcements on EFSF loan maturity changes exerted the most significant ratings impact. Shortly after their announcement, Moody's published a dedicated rating commentary saying that the extensions were credit positive for the two countries. Later in 2013, Moody's took positive rating actions on both sovereigns, identifying the maturity extension explicitly as one of the reasons for the improved liquidity position, which led to the favourable assessment. S&P also mentioned the reduction in near-term financing needs and the overall improvement of the sovereign's financing profiles when it took positive rating actions in 2013 and 2014.

The analysis shows that the changes to the EFSF loans had a material impact on investors' and rating agencies' perception of the countries' ability to service their outstanding debt. This finding has important implications. By providing cheaper and longer-term financing, the EFSF operations create room for market financing. Moreover, the substantially lower medium-term debt-servicing burden that the EFSF loans deliver reduces the short-term sustainability risk.

Macroeconomic and financial environment

In 2014, euro area economic growth sustained its slow but steady rise, maintaining the course set out at the end of the previous calendar year. Domestic activity bolstered the improvement, with household spending making the most notable contribution. Still, the improved average gross domestic product (GDP) masked Member States' diverging national growth rates. And, despite the positive growth trend, inflation decelerated, driven by falling global energy prices towards the end of the year. The overall fiscal stance of the euro area became clearly less restrictive with monetary policy easing further given low inflation.

The major themes in the financial markets throughout the year were the divergence in monetary policies across major economies and future expectations of such divergence. Escalating geopolitical tensions and concerns about a potential global health scare in the early part of the year raised doubts about the robustness of the recovery. An unexpected collapse in oil prices in the second half of the year improved the outlook for oil-importing regions such as the euro area. As a result of the oil price collapse, lower inflation set the stage for expectations of additional ECB measures. Towards year-end, Greece burst to the forefront of euro area concerns, rekindling old anxieties.

DIVERGING PATTERNS ACROSS THE GLOBE

World economic output continued to grow in 2014. Macroeconomic data showed developed economies diverging, with the United States (US) and the United Kingdom (UK) improving while Japan lagged. US concerns on the slack in the economy delayed the timing of the Federal Reserve's expected first rate hike in this cycle, while the Bank of Japan, attempting to foster economic growth, stepped up its very accommodative monetary policy stance.

In emerging markets, the fall in oil and commodity prices undermined the economies of net oil-exporting nations, like some countries in Latin America and the Middle East as well as Russia. Geopolitical tensions in some of these countries, like Ukraine and Russia, also lowered economic performance over the year. China's growth continued its moderate path, mostly due to the rebalancing of its growth model, which requires some price declines in real estate, credit, and investment markets. Ongoing structural reforms, coupled with lower oil prices and a buoyant US recovery, should support Chinese domestic consumption and growth perspectives. In contrast, other emerging economies such as India performed better than expected in 2014.

ANTICIPATING MONETARY EASING: EURO AREA FINANCIAL MARKETS

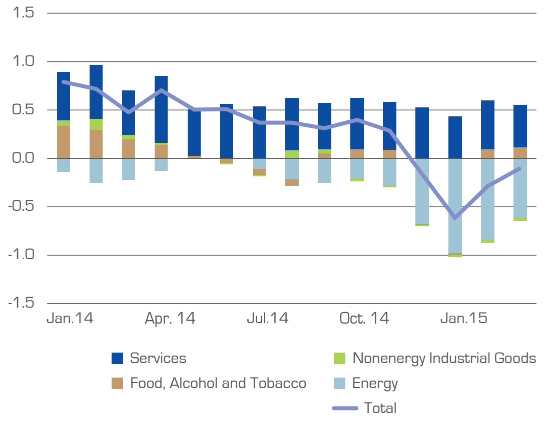
Consumer prices extended their 2013 deceleration throughout 2014. In June, spurred by concerns about low inflation rates and in particular low credit growth to households and non-financial corporations, the ECB cut its key rates and introduced another easing initiative, Targeted Longer-Term Refinancing Operations (TLTRO), which it planned to conduct later in the year.

Later in the summer the spectacular drop in oil prices propelled already declining inflation rates yet lower. Inflation fell into negative territory in December (Figure 3). In June, the ECB set a negative deposit rate, an unprecedented step for a major central bank. Given the deterioration in medium-term inflation expectations, slow growth, and the unsatisfactory transmission of credit to the real economy, the ECB launched several other new measures in September and October. It embarked on its asset-backed securities and covered bonds purchase programme in what would be the first steps towards a full quantitative easing programme announced in January 2015.

Wolfgang Schäuble
Germany

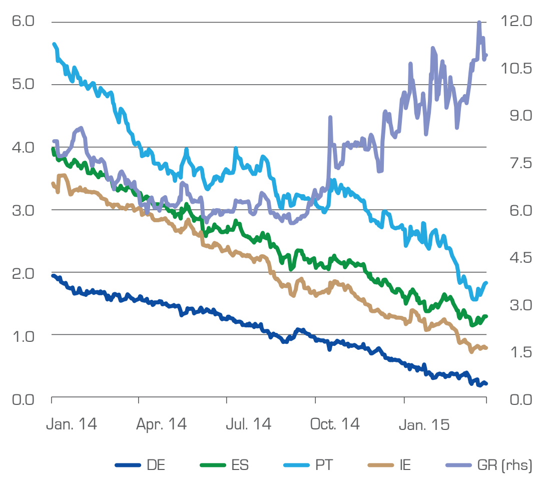
The European Stability Mechanism, as our last line of defence against crises of confidence, is an effective instrument for safeguarding the financial stability of the euro area. It is based on the principle of solidarity in return for sound public finances and the implementation of structural reforms to improve the competitiveness of programme countries. This approach has proved its worth as demonstrated by Ireland, Portugal and Spain. As we look towards the future, the ESM will continue to serve as an integral part of our efforts to prevent and combat sovereign debt crises in the euro area.

Figure 3. Contribution to harmonised index of consumer prices inflation rate (%)



Sources: Eurostat and ESM calculations

Figure 4. Selected 10-year yields in the euro area (%)



Source: Bloomberg

Given the expectations for, and the implementation of, the monetary policy easing measures, the yields of all euro area debt markets ended 2014 lower than they started it, with the exception of Greece (Figure 4). These measures also tightened the yield spreads to the highly rated countries and flattened the yield curve, with the yields on longer-dated debt instruments declining more than those on the short end. In particular, the 10-year yields in former euro area beneficiary Member States such as Portugal and Spain declined by around 315 and 240 basis points, respectively, over the year. As the comparable 10-year German yield declined around 140 basis points, the Portuguese and Spanish yield spreads declined by some 175 and 100 basis points to Germany, respectively.

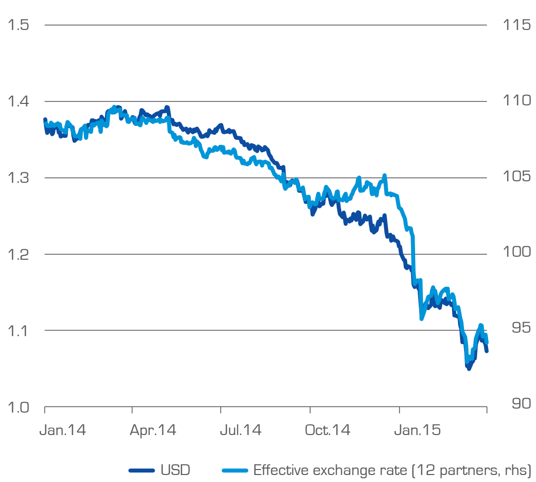
Sven Sester
Estonia

> The ESM is an important instrument for safeguarding financial stability in the euro area. The ESM has already proved its necessity by helping Cyprus and Spain during their financial difficulties and has contributed to the enhanced credibility of the euro area.

The expectations for monetary policy easing measures also resulted in a gradual depreciation of the euro. As of May, the euro started declining against all major currencies. At year-end 2014, the euro had depreciated around 30% against the US dollar, and the nominal effective exchange rate had fallen around 12% since May (Figure 5). The currency drop will benefit most of the euro area countries, because they have high trade volumes with countries outside the euro area. Ireland and Cyprus, which export around 60%–70% of their goods beyond the euro area, will profit in particular from this trend.

Euro area equity markets held relatively stable in the first part of the year. Towards the end of the year and the beginning of 2015, equity prices gained rapidly, mainly attributed to monetary policy easing expectations, the corresponding improving economic outlook and capital inflows from foreign investors. From early 2014 through the first quarter of 2015, the EuroStoxx gained around 20%, with regional returns ranging from around -35% in Greece to around +30% in Ireland. Despite the rise in stock prices, company earnings have not followed suit, with the price-earnings roughly doubling since 2011. Banking sector stocks also climbed in line with the equities trend, buoyed by enhanced confidence from the successful Asset Quality Review (AQR). In particular, banking stock prices in

Figure 5. Euro effective exchange rate and euro/US dollar rate



Sources: ECB and Bloomberg

France, Germany, and Italy have risen around 20%, 20% and 15%, respectively, since the late October AQR results. The boost in financial sector confidence also seemed to support interbank funding in both secured and unsecured markets.

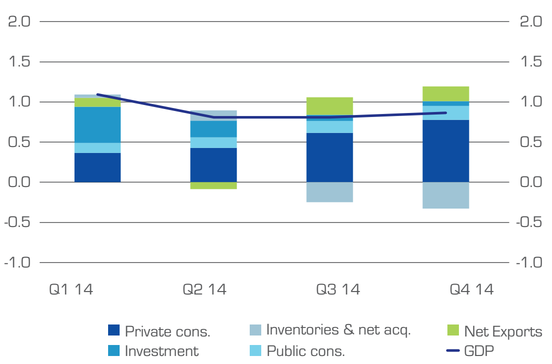
Michael Noonan
Ireland

The establishment of the ESM is an essential part of the euro area's crisis resolution mechanism and in that capacity it contributes significantly to economic confidence. The highly professional approach of the ESM management and staff has built an organisation which has the confidence of its members and strong credibility in the financial markets.

ACCELERATING EURO AREA GROWTH

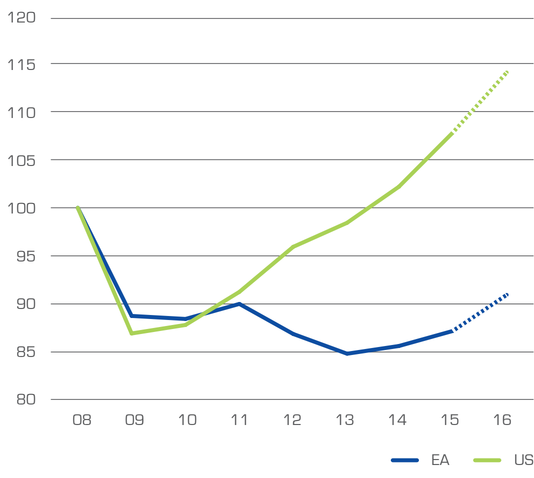
Euro area GDP increased by an annual 0.9% rate in 2014, benefitting primarily from higher consumer spending, and to a lesser extent from government spending (Figure 6). Towards the end of the year, lower oil prices and a weaker currency boosted economic output. Nonetheless, disparities among euro area Member States remained. A few recorded shrinking output while others posted growth of varying degrees. Export performance improved on the back of the euro's sharp depreciation. Investment remained subdued compared to levels prior to the crisis, both for public and private investment, and lagged behind investment rates achieved, for example, in the US (Figure 7).

Figure 6. Contribution to annual euro area GDP growth (% of GDP)



Sources: Eurostat and ESM calculations

Figure 7. Investment gap between euro area and US (2008=100)



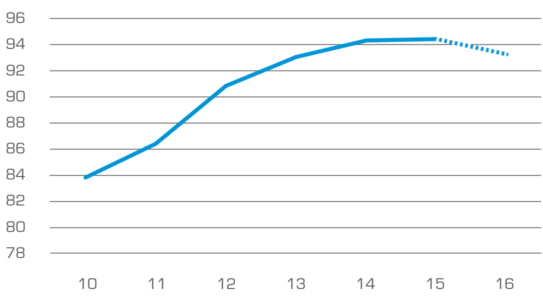
Sources: EC, *Winter Economic Forecast 2015* and ESM calculations

In a stronger growth environment, investment is expected to improve, but it will take some time to recover from the current weakness in capital formation. Further improvement in investment remains critical to securing stable long-term euro area growth.

The depreciation of the euro's effective exchange rate further boosted euro area export growth, despite an initial slowdown of economic activity in traditional export markets that undercut demand. Euro area unit labour costs rose as productivity trends failed to offset the area's upward wage trend. However, countries with financial assistance programmes gained competitiveness. Unemployment fell to 11.3% in December 2014, with youth unemployment encouragingly falling along with it. Consumer confidence jumped as disposable income rose while economic sentiment remained positive. In this context, the correction of external imbalances continued in 2014. The current account balance is expected to rise further to 2.8% from 2.4%, with Germany, Ireland, and the Netherlands in particular putting up strong numbers.

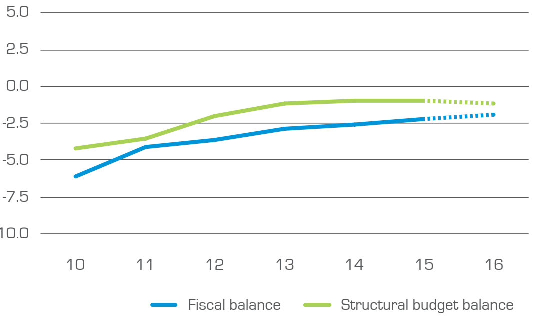
At the same time as these economic developments, the euro area's fiscal situation continued to improve. General government debt levels are set to rise compared to previous years, peaking at around 94% of GDP. These are then expected to decline gradually over the next several years (Figure 8).

Figure 8. Euro area public debt (% of GDP)



Sources: EC, *Winter Economic Forecast 2015*

Figure 9. Euro area fiscal and structural budget balance (% of GDP)



Sources: EC, *Winter Economic Forecast 2015*

Headline fiscal balances continued to gain ground, driven by increased economic activity benefitting from a more neutral fiscal stance as measured by the structural balance figures. The euro area fiscal balance in particular showed moderate improvement as the overall deficit is set to narrow to 2.6% in 2014 from 2.9% of GDP in 2013 (Figure 9).

In 2014, countries that benefited from an EFSF or an ESM financial assistance programme continued on the path of fiscal consolidation and partially implemented further structural reforms. Several euro area Member States, which until recently were under a financial assistance programme, accessed capital markets. Cyprus, Ireland, Portugal, and Spain were successful and active in the market when they tapped existing bonds as well as issued new series. The case of Portugal is worth noting as it is the most recent to exit successfully an EFSF financial assistance programme, in May 2014. The major rating agencies assessed the situation positively for most of the euro area programme countries, in particular Ireland and Spain, which both received upgrades from all three major rating agencies after successfully exiting their programmes. Greece represents an outlier in this respect.

While indicators are moving in the right direction, improving economic conditions often lead to diminished pressure to continue with structural reforms. At the same time the declining level of investment

gives cause for concern; it raises the question as to whether the recovery can be strengthened to attain high long-term growth rates. The structural reforms implemented in programme countries are starting to bear fruit, and other countries with weak growth prospects could follow this route. Given ageing populations, structural reforms are crucial for unlocking investment and growth across the euro area. Against that background there is a strong call for ambitious structural reforms in many countries.

CONSIDERING THE RISK FACTORS AHEAD

Overall the risks to a sustained recovery are rather balanced. The benefits of low energy prices, the large effective exchange rate depreciation, and lower yields through the ECB's asset purchase programme have been substantial. Although they have not yet shown their full impact, these factors could accelerate economic growth beyond current market expectations and official sector forecasts. Several risk factors, however, have the potential to throw the positive trends off track, in particular if these factors were to occur simultaneously. Geopolitical tensions have led to the imposition of economic sanctions on Russia, curtailing economic activity in return. Within the euro area, Greek political and fiscal developments, if not resolved quickly, could translate into higher uncertainty and therefore lower confidence in the euro area as a whole. Reform fatigue may either leave the implementation of previously agreed measures unfinished or reverse them, with potentially negative effects on budget targets and future growth prospects. Lastly, the lack of investment spending and growth friendly fiscal policies may result in growth momentum fading, losing a window of opportunity to reinforce the recovery.

Programme country experiences

IRELAND

Ireland re-established sustainable and durable market access in 2014, after successfully concluding its EFSF financial assistance programme at the end of 2013. During 2012 and 2013, it had engaged in occasional opportunistic funding and liability management exercises. In 2014, Ireland enjoyed strong growth and the general government deficit fell within required parameters. Maintaining the programme's spending cuts and tax increases, and continuing consolidation efforts, will be necessary to reduce its high public debt.

The Irish economic recovery gathered pace during 2014. Annualised gross domestic product (GDP) grew at 4.8% in 2014, the fastest growth rate in Europe, on the basis of current estimates. Gross national product, which strips out the effect of the multinational sector (or foreign-owned subsidiaries of larger companies based abroad), grew by 5.2% on the year. This is a welcome development given the heavy reliance on net exports to produce growth since the beginning of the crisis. The continued improvement in the labour market has facilitated this turnaround. Unemployment fell to 10.4% at the end of 2014 from a peak of 15.1% in early 2012. The housing market has also started to recover, with double-digit price increases nationally. House prices, however, remain far below their previous peaks, and new house completions are below equilibrium.

The fiscal adjustment process continued apace in 2014. The 2014 general government deficit declined to 4% of GDP, well within the 5.1% limit set under the Excessive Deficit Procedure. Higher-than-expected economic growth increased tax revenues, while positive financial market developments decreased the cost of Ireland's debt interest payments. Definitional changes in Eurostat's accounting framework provided a further reduction of the debt-to-GDP ratio as they resulted in an upward revision of Irish (nominal) GDP by just over 6%. Despite a decrease of approximately 13%, resulting from the liquidation of the Irish Bank Resolution Corporation, the forecast for public debt remains high at 110% of GDP. Competitiveness gains continued to bring benefits, as the 2014 current account surplus was 6.2% of GDP.

While 2013 was the year of the successful exit from the financial assistance programme, 2014 confirmed Ireland's complete return to market access. Irish sovereign bond yields continued their downward trajectory, with the 10-year bond yield at 1.25% at the end of the year. The major ratings agencies upgraded Irish sovereign bonds in 2014 and awarded them stable outlooks. These positive market developments have allowed for the early repayment of a portion of the IMF loans, facilitated by a waiver by other official creditors, including the EFSF, of their right to any early repayments. This process could deliver absolute savings of up to €2.1 billion for the period from 2015 to 2020.

Financial sector developments during 2014 were also positive. A reduction in costs of funding, coupled with an inflow of customer deposits, allowed Irish banks to return to profitability. Stress tests showed that the two major banks were well capitalised and the capital shortfall identified in a third bank was too small to require further government assistance.

The continued monitoring of Ireland's payment ability under the Early Warning System showed that Ireland currently faces no difficulty in meeting its loan service payments. Despite these positive developments, there have been growing calls to reverse some of the budgetary spending cuts and tax increases made under the financial assistance programme. Some reform fatigue has become apparent, as the EC also noted. To reduce its very high public debt levels, Ireland will need to maintain a primary balance in the coming years. Any weakening of the government's revenue-raising capacity would undermine this goal.

Programme country experiences

PORTUGAL

During 2014, Portugal kept to the adjustment path, exited its EFSF financial assistance programme and regained full market access, including making a return to regular bond auctions. GDP expanded on a yearly basis for the first time since 2010, mostly due to a recovery in domestic demand. Both the fiscal and external imbalances continued to improve. Further fiscal consolidation and structural reforms are needed to reduce the still high level of public debt.

After several years of recession, Portugal returned to growth with a 0.9% GDP expansion in 2014. The composition of growth shifted from that of previous years with domestic demand expanding by 1.4% and private consumption by 2.1%. Net trade figures undermined GDP. Despite an export increase of 3.4%, buoyant domestic demand drove a rebound of more than 6% in imports. The current account balance deteriorated somewhat but still posted a surplus of 0.6% of GDP in 2014, down from a 1.4% surplus in 2013.

The fiscal adjustment continued, as the budget deficit declined to 4.5% of GDP from 4.9% in 2013, or, excluding one-off factors, to 3.4% of GDP in 2014 from 5.2% in 2013. As in previous years, this deficit decline stemmed mostly from an outperformance in fiscal revenues, driven by improved domestic demand and a stepped-up fight against fraud and tax evasion. Government spending exceeded the initial budget target due both to negative rulings from the constitutional court, which again cancelled some of the planned spending cuts, and to an increase in spending in intermediate consumption.

Government debt increased to 130.2% of GDP at the end of 2014, up from 129.7% in 2013, under the new Eurostat economy accounting rules. This stock of debt included a cash buffer of close to €15 billion (6.6% of GDP) held by the Portuguese Treasury and Government Debt Agency.

During the year, financial market perceptions continued to improve, after Portugal was able to exit the economic adjustment programme without further assistance. Portugal succeeded in fully establishing market access. It used syndicated deals and also returned to regular auctions. Portugal issued at increasingly longer maturities, even issuing a 15-year bond, the longest maturity issued since 2010.

The financial sector continued to deleverage while profitability is slowly normalising in a challenging environment. Portuguese banks' capital position improved, as shown by the SSM stress tests. This reassured investors when the Banco Espirito Santo (BES), a major Portuguese bank, failed in summer. Following its resolution, it was split into a good and a bad bank. The Portuguese government expects to conclude the sale of the good bank by June 2015. Notwithstanding some volatility in July 2014, the resolution of BES did not lead to any contagion either to other banks or to the sovereign bond market.

The continued monitoring of Portugal's payment ability under the Early Warning System shows that Portugal currently faces no difficulty in meeting its loan service payments. Going forward, despite the positive economic and financial market developments in 2014, and the end of the adjustment programme, the sustainability of government debt remains challenging given its high level and Portugal's still modest growth prospects. Most market participants expect a clear commitment to fiscal discipline. Portugal will need to continue to adhere to agreed fiscal targets and continue to implement structural reforms set under the European framework to reduce its debt level significantly.

Programme country experiences

GREECE

Greece's economic adjustment programme was designed to restore the sustainability of public finances, restructure and stabilise the financial system, and support long-term growth through an ambitious structural reform agenda. By autumn 2014, the economy had stabilised, growing again after six years of recession and a successful adjustment of the external and fiscal balance. However, Greece then lost the cautious recognition it was getting from market participants on its achievements. The conclusion of its programme with the EFSF and the IMF was postponed due to a lack of progress since summer 2014. Greece needs to provide a clear and credible way forward to restore market trust and return to a sustainable growth path.

The latest successful programme review was completed in April 2014 and the last tranche of the agreed EFSF disbursement took place in August 2014, after the completion of agreed milestones. Due to delays in concluding the final programme review, the Facility has been extended twice since December 2014 and it is now set to expire at the end of June 2015.

The economy stabilised in 2014 after six years of recession, with real GDP growing by a seasonally adjusted 0.7%. The economic growth registered in 2014 was mainly driven by a recovery in domestic demand, supported by considerable gains in the tourism sector. The external sector continued to contribute positively to growth, with exports outpacing imports. But the decline in public consumption persisted in 2014, albeit at a lower rate than in previous years. On the supply side, wholesale and retail trade contributed the most to growth.

Preliminary data suggest that in 2014 the government missed the primary surplus programme target of 1.5% of GDP. This fiscal underperformance stemmed primarily from tax revenue slippages, given that overall political uncertainty ahead of the January 2015 parliamentary elections influenced taxpayer behaviour during the last months of 2014.

The external adjustment continued in 2014, with Greece recording a current account surplus (0.9% of GDP) for a second consecutive year. The improvement reflects a substantial increase in the services surplus, which more than offset an increase in the goods deficit. Price competitiveness has improved notably from 2012 onwards due to labour cost adjustment and the implementation of competition-enhancing reforms, which facilitated price and wage flexibility. Ambitious labour market reforms yielded results, with Greece more than recovering the cumulative loss in labour cost competitiveness observed between 2000 and 2009.

Greece's improving economic performance, policy reforms and the broadly favourable market conditions gained investors' recognition during the first half of 2014. Greece managed to come back to the markets by placing new 5-year and 3-year bonds at relatively favourable yields. By mid-October 2014, however, the confidence Greece was building in financial markets was rapidly undone, due to weaker programme implementation. Market participants made clear that the perception of regained market access was premature, triggering a sell-off.

Despite the clear progress achieved in fiscal adjustment and competitiveness so far, the continuous delays in programme implementation, accompanied by political uncertainty, have taken their toll on the Greek economy and budget. The liquidity and funding conditions for the economy and the financial sector grew very strained during the first quarter of 2015 as a result of the ongoing dialogue between the Greek government and its official sector creditors. For Greece to regain market confidence and reap the benefits of the substantial adjustments made to date, the authorities will need to demonstrate their determination to continue improving fiscal sustainability, preserve financial sector health, and boost growth and employment through robust implementation of structural reforms. These elements would be crucial for Greece's long-term outlook and gradual return to accessing market financing.

HOW GREECE BENEFITTED FROM EUROPEAN DEBT RELIEF

Euro area Member States have taken several steps to ease the lending terms for Greece to support its ability to service its debt burden, principally through lower financing costs and longer maturities.

The first European assistance instrument, known as the Greek Loan Facility (GLF), was amended in June 2011, when the maturity was extended by five years to a total of 10 years, the grace period was lengthened to 4.5 from three years, and the margin was lowered by 100 basis points, to 2% in the first three years and 3% thereafter. This change was superseded by the second amendment in March 2012 where maturities were extended to 15 years, the grace period raised to 10 years, and the margin reduced further to 150 basis points over the entire period.

In November 2012, the second Greek financial assistance programme included additional debt alleviation measures. Worse-than-expected macroeconomic developments, missed targets and incomplete programme implementation meant additional measures needed to be taken to reduce financing needs and to support the sustainability of Greek government debt. Therefore, the Eurogroup approved a broader set of measures on the GLF and EFSF loans:

- reduction of the GLF interest rate margin by 100 basis points;
- cancellation of the EFSF guarantee commitment fee;
- deferral of EFSF interest payments on loans under the Greek Master Financial Assistance Facility Agreement by 10 years;[3]
- return of the Securities Markets Programme (SMP) profits (when the ECB bought Greek government bonds with a discount in the secondary market and made a profit at maturity);
- extension of the GLF to 30 years and EFSF weighted average maturities to 32.5 from 17.5 years.

The low financing costs of the European facilities reduced Greece's debt servicing burden, thereby providing authorities with greater fiscal flexibility. The GLF and EFSF rates remain well below market rates. Due to the relief measures and market conditions for EFSF funding, the EFSF lending rate for Greece, which reflects the market situation, currently stands at around 1.35%. The EFSF rate compares favourably with the current IMF lending rate of 3.6%. It also remains far below the roughly 5% rates that Greece has had to pay for corresponding maturities over the past decade and current market rates. Financing at EFSF and GLF rates therefore entails an important support component, because they are alternatives to other, more costly sources of financing.

The measures correspond to substantial economic debt relief, with effects that transcend the enhanced fiscal room for manoeuvre provided to Greece. Considering these maturity extensions and interest rate deferrals over the entire debt servicing profile from a net present value (NPV) perspective shows a reduction in the overall debt burden and reveals implicit savings. The NPV approach consists of discounting the difference between the future cash flows of the loans benefitting from lower financing costs and debt relief measures and the cash flows of the same loans had they not benefitted from the relief measures.[4] Stretching out principal repayment schedules over such an extended period of time, along with interest payment deferral, imply that these payments account for substantially less in NPV terms when assessed from the Greek side taking into account the financial market perspective.[5]

3 Not applied to Private Sector Involvement (PSI) and bond interest facilities, which correspond to roughly 25% of the overall EFSF loan to Greece.

4 For the calculation of the interest Greece would have paid in the markets, the historical 10-year German bund rate plus a theoretical market spread of Greece at the starting date of each EFSF loan tranche is used. For the calculation of the interest applicable to the EFSF loans to Greece, projections of the EFSF cost of funding are based on the estimate of the funding volumes that the EFSF has to achieve in the future. The NPV gain is derived from the difference between these two flows of interest payments. The discount curve is derived from the German bund plus the theoretical market spread for Greece as of calculation date.

5 It should be noted that this does not entail any financial loss or write-down from an EFSF perspective. The EFSF is fully repaid; Greece has to cover any financing costs related to the agreed interest rate deferral in line with the amendment of the Master Financial Assistance Facility Agreement.

The economic reduction of the debt burden and implicit savings from the various relief measures described above leads to NPV savings equivalent to 49% of Greece's 2013 GDP. The overall figure comprises an NPV reduction for the EFSF facilities of 34% of GDP, of which 7% of GDP can be attributed to the extension of maturities and interest rate deferral, and 27% of GDP can be attributed to the savings from the financing at EFSF rates compared to market rates for Greece. To this number, one can add the impact of the extension of maturities and the lowering of the margin for the GLF. This adds another 10% of GDP in NPV reduction. Finally, the return of SMP profits adds up to 5% of GDP. This overall NPV savings figure as a percentage of GDP and its breakdown is based on theoretical assumptions of the interests Greece would have paid in the markets, compared to estimates of the future EFSF cost of funding.

From a Greek perspective, the debt relief measures taken by its European creditors provide a substantive benefit in fiscal space and overall payment profile. It cannot be argued that the debt level is unsustainable by merely looking at the aggregate nominal debt to GDP ratio. A proper sustainability analysis must consider the structure of Greek debt. Payment obligations over the years until 2023 are minimal. Thereafter, the repayment is stretched out over several decades which, combined with favourable lending rates, results in an overall high but sustainable debt – provided that Greece continues its reform agenda.

Programme country experiences

SPAIN

The Spanish banking sector remains on a solid path to recovery, following the successful completion of the ESM financial assistance programme which aimed at repairing the banking system. All Spanish banks passed the 2014 stress tests showing safe capital ratios. The privatisation of the banks recapitalised in 2013 is ongoing. In addition, structural reforms are paying off in high output growth. Reforms and fiscal policies in line with the European framework have strengthened fiscal sustainability and will continue to do so.

Spanish banks further improved profitability in 2014 due to lower impairment charges and cost reductions, despite a slight decrease in operating revenues. Although asset quality remains a challenge, non-performing loans (NPLs) continued to decline at most banks. The stock of NPLs decreased by 12.5% from a January 2014 peak to December 2014. Over the same period, the NPL ratio declined only slightly to 12.5% from its peak of 13.6% in January 2014 due to the continued deleveraging of the banks' loan books. The economic recovery is expected to support further improvements in asset quality in 2015. Banks' liquidity remains comfortable and loan-to-deposit ratios have improved to more sustainable levels. While the reliance on ECB funding has fallen substantially, it still remains high for some recapitalised banks.

The economy is recovering, the latest macroeconomic developments show. Growth accelerated steadily throughout 2014 with fourth-quarter figures at a healthy 2.0% year-on-year basis. Overall, in 2014, domestic demand provided strong support, contributing 2.1% to growth compared to -2.6% in 2013; however, the contribution of external demand to growth turned negative to -0.7% compared to 1.5% in 2013. In 2014, growth in imports outpaced exports (7.6% vs. 4.2% annual growth), linked to the pick-up in internal demand. The current account balance remained positive at 0.6% of GDP, compared to 1.5% in 2013, and is expected to strengthen further in 2015.

The fiscal consolidation process continued and the overall fiscal deficit of the general government excluding financial assistance decreased to 5.7% of GDP in 2014 from 6.3% in 2013. This is slightly below the Excessive Deficit Procedure target and two decimals above the objective set in the Stability Programme (5.5% of GDP). The 4.2% deficit target for 2015 still looks ambitious, albeit within reach. The government included a number of expansionary measures in the 2015 budget, mainly reducing personnel and corporate income tax rates. The lower tax rates may weigh on fiscal performance. However, if domestic demand continues to increase its contribution to growth, positive growth momentum may help to compensate for the negative effect of lower tax rates.

The Spanish sovereign has always kept access to capital markets. Since late 2012 financing costs have been declining. In 2014, the risk premium on Spanish 10-year bonds compressed by over 100 basis points and the yield declined by over 250 basis points, driven by a better macroeconomic outlook, falling commodity prices, and ECB interventions, such as deposit rate cuts, purchase programmes, and the announcement and execution of refinancing operations. As a result, yields on Spanish debt hit record lows across the entire curve, which is likely to lower debt servicing costs in the medium to long term.

Since the second post-programme mission carried out in October 2014, economic and financial developments have continued to improve. The ESM's Early Warning System exercise provides a continuously positive assessment of Spain's ability to honour its ESM loan payments. Nonetheless, Spain still faces challenges. With debt approaching 100% of GDP, fiscal performance is critical given subdued inflation rates and still moderate real GDP growth. Further structural reform measures to reduce labour market segmentation and the announced reform of professional services and associations would also pave the way for higher near-term growth.

Programme country experiences

CYPRUS

Cyprus started reaping the benefits in 2014 of the sound policies it was implementing under the ESM financial assistance programme agreed in 2013. During 2014, Cyprus exceeded programme targets in some key areas, such as on the fiscal side. The situation in the banking sector continued to improve gradually and capital controls were fully withdrawn in April 2015. The implementation of structural reforms lagged, however, and full implementation is crucial to improve growth prospects further.

The recession continued in 2014 but proved shallower than expected with the economy contracting by 2.3%. Internal adjustment also continued but at a slower pace than previous programme projections. Inflation was marginally negative as pressures on disposable income continued and credit conditions remained tight. Unemployment declined for the first time since 2008, mainly due to labour force contraction. Debt-to-GDP reached 107% and is expected to peak at around 116% in 2015, lower than the previous forecast of 126%. This reduction was primarily driven by Eurostat's upward revision of GDP by around 10% due to changes in definition from the implementation of the ESA 2010 accounting framework.

As to public finances, consolidation measures and improved tax collection coupled with tight expenditure controls and a reduced wage bill more than offset the recession's impact. This resulted in a primary surplus of 2.8% in 2014, two years ahead of programme targets. Fiscal risks remained given the large amount of government guarantees, which were close to 20% of GDP. On this front, the ESM is providing technical assistance to improve the assessment and management of financial risks associated with existing and new government guarantees.

The reform momentum weakened towards year-end 2014 with privatisation and other key reforms falling behind schedule after important structural reform steps were taken early in year. The reform push needs to be reinvigorated. On 17 April 2015, parliament passed insolvency legislation and repealed the suspension of the foreclosure law. If this foreclosure regulation is implemented swiftly, it paves the way for the completion of the ongoing review.

The financial sector has been adequately capitalised but the very high level of NPLs weighed on profitability and outlook. Cypriot banks successfully passed the Comprehensive Assessment with only one bank, Hellenic Bank, reporting a small capital shortfall, which it has since covered through a rights issue to existing shareholders. System-wide NPLs increased but at a much slower rate, reaching 49.7% at end-November 2014, and were likely to peak in the first half of 2015. Deposits have stabilised and the full relaxation of capital controls in April 2015 had a small positive impact on overall system deposits, even with banks decreasing deposit rates.

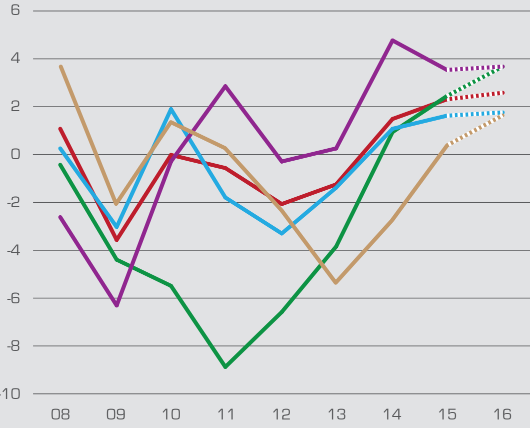
Cyprus managed to tap the market for the first time in three years with a €100 million issuance of a six-year Eurobond in April 2014 and an oversubscribed issuance of a five-year Euro Medium Term Note (€750 million) in June 2014. The authorities continued to work towards a sustainable return to markets. The ESM is providing technical assistance focused on optimising the operations of the Public Debt Management Office.

With the passage of insolvency legislation and the repeal of the suspension of the foreclosure law, Cyprus moved closer to completing the review and bringing the programme back on track. Structural reforms, however, remained behind schedule. If the authorities succeed in reinvigorating programme implementation and complete the next reviews, the ESM and IMF can proceed with the next disbursements over the remaining programme period.

HOW MACROECONOMIC IMBALANCES ARE BEING CORRECTED

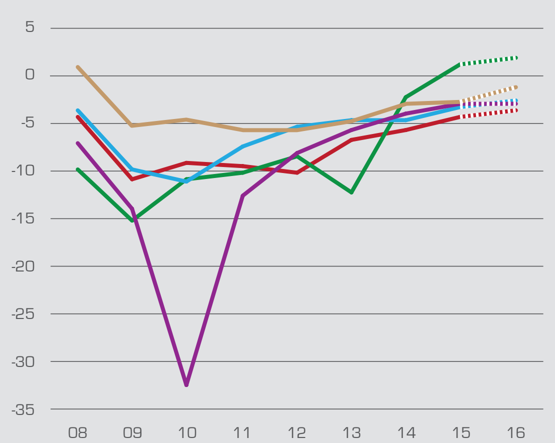
ECONOMIC RECOVERY IS PICKING UP...

Figure 10. Annual real GDP growth (%-change)



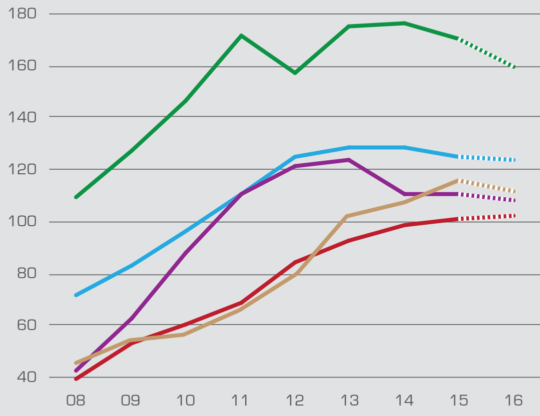
DEFICIT REDUCTION POLICIES ARE PAYING OFF...

Figure 11. Fiscal balance (% of GDP)



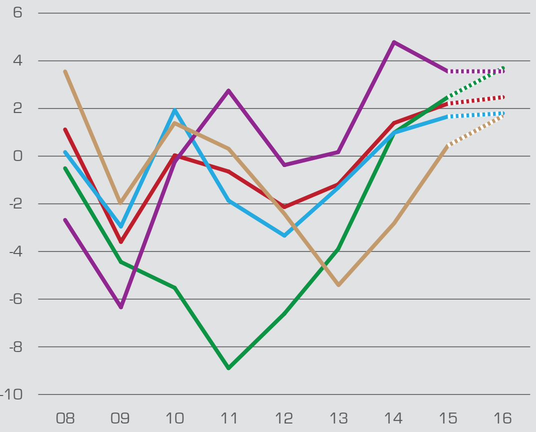
HIGH DEBT TO GDP IS STILL A CHALLENGE...

Figure 12. Public debt (% of GDP)



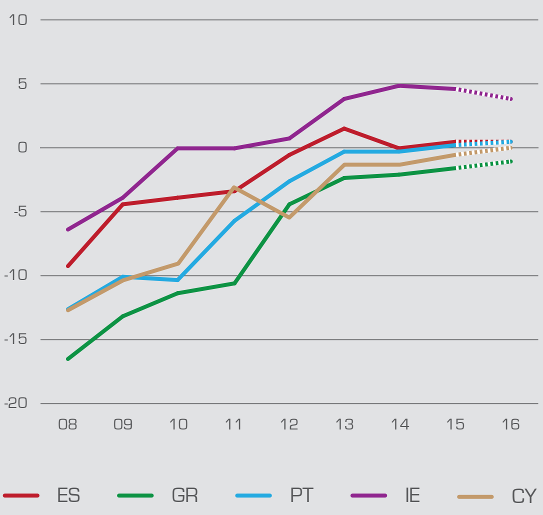
INTERNAL DEVALUATIONS ARE RESTORING COMPETITIVENESS...

Figure 13. Annual change in Nominal Unit Labour Costs (% change)



EXTERNAL IMBALANCES IN THE PERIPHERY ARE RECEDING...

Figure 14. Current account balance (% of GDP)



Sources: EC, *Winter Economic Forecast 2015*

ESM LAUNCHES FIRST TECHNICAL ASSISTANCE PROJECT

The ESM kicked off its first technical assistance project in 2014, advising the Public Debt Management Office (PDMO) of Cyprus how to optimise the effectiveness of its core work and strengthen its risk management.

Generally, technical cooperation activities are an ancillary activity to support a financial assistance mandate. These advisory services transfer knowledge to the beneficiary Member State, supporting the relevant programme country in restoring market access on a lasting basis and increasing its capacity to repay its creditors, including the international financial institutions (IFIs).

Technical assistance can be provided on a case-by-case basis to a beneficiary ESM Member State, upon its request and in the areas where the ESM has established in-house skills and first-hand experience, such as advising Debt Management Offices. The ESM cooperates with other IFIs and European institutions in providing coordinated technical advisory services and also participates in other IFIs' technical assistance missions.

At the request of the Cypriot authorities, the ESM is focusing on two aspects of the PDMO's activities:

- assisting it in defining its organisational structure, including on information technology infrastructure, internal controls and staffing;

- enhancing its market intelligence function, covering investor relations and the communication of market information.

The ESM has developed its recommendations for the Cypriot authorities based on international best practice. To provide useful and appropriate advice, the ESM also took into consideration the PDMO's own specificities and constraints. The ultimate goal is to help the PDMO develop the skills of its staff and assist Cyprus in regaining sustainable market access.

02.

ESM ACTIVITIES

How the ESM processes its financial transactions

Financial transactions at the ESM are conducted by three different teams: Funding, Investment and Lending. These teams can be regarded as our 'front offices' – they are responsible for raising funds by issuing bonds and bills; for investing funds – most importantly, investing the paid-in capital from ESM Members; and for providing loans to beneficiary Member States. All the transactions carried out for this purpose need to be validated and processed, which is the area of activity of the ESM's Middle and Back Office Division.

The task of the Middle and Back Office is to correctly record, control, process, pay for and report on every transaction. The Middle Office embeds risk management and control procedures into transaction processing to guarantee that the ESM adheres to its key policies, such as on risk, and does not engage in any detrimental activities. In this way, it helps to protect its assets and reputation. The Back Office ensures that the securities and financial instruments bought or sold are exchanged for the correct amount of money at the appropriate time and with the right counterparty. The ESM has chosen a Middle and Back Office operating model that mixes internal and outsourced activities, some of which are mentioned here.

The following steps provide an overview of how the Middle and Back Office handle financial transactions for the ESM's three front-office teams, Funding, Investment and Lending.

SECURITIES ISSUANCE.

The Funding Team:
The front-office Funding team issues securities, specifically bonds or bills, to raise funds for the ESM and the EFSF's financial assistance programmes for beneficiary Member States. Its work is guided by the ESM funding plan and Member State lending needs.

Trade validation.

The Middle Office:
- Verifies the accuracy of the issuance.
- Checks that the system can accommodate the new issue.
- Updates the internal database with the new issue.
- Ensures the information on the issue is accurately recorded in the internal information technology system.

Trade matching.

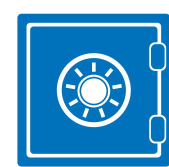
The Back Office:
- Orders an external bank or clearing house to check that the ESM trade details match those of the institutions purchasing the securities.
- Instructs the 'custodian' on the characteristics of the issue like the amount, price and maturity, ultimately ensuring a proper settlement process.

The 'custodian' is a specialised financial institution that holds securities and assets for safekeeping in electronic or physical form. The custodian acts as a central information hub, keeping track, for example, of who currently owns the issue, since the original issue purchasers may sell the securities on.

Post-trade activities.

The Back Office:
- Ensures the accuracy and validity of the financial information on the issue.
- Monitors the settlement of all funding trades as well as future cash flows. It uses a standard delivery versus payment (DVP) settlement system, which ensures that delivery is made only if a payment takes place (The system acts as a link between a funds transfer system and a securities transfer system).
- Reports the list of trades executed to the European Investment Bank which takes care of the financial accounting.

FUNDING



INVESTMENT

TRADE EXECUTION.

The Investment Team:
The ESM's core investment activities are focused on investing the proceeds of the paid-in capital and the reserve fund, thereby contributing to the ESM's credit-worthiness. To do so, it initiates a trade by, for example, selling or buying a security, like a bond or a bill. In this process, it takes into account ESM risk guidelines, predefined limits and investment policy.

Trade validation.

The Middle Office:
- Closely monitors trading activity.
- Verifies that the trade details are correctly recorded in the system in a timely manner.
- Maintains IT core financial data to ensure all trade details are correct.

Trade matching.

The Back Office:
- Liaises with the outsourced Back Office provider and sends them all ESM investment securities trade details for settlement purposes.

Post-trade activities.

The Back Office:
- Closely monitors the settlement process.
- Monitors coupon and redemption income as well as cash needs or excess cash.
- Performs cash and securities reconciliation.

The Middle Office:
- Reports on daily investment trade activities and positions.
- Reports any breach of investment guidelines (limits checks, concentration risk, liquidity risk), operational risk issues, audit trails and/or limit transgression.
- Checks off-market trade prices.
- Monitors financial instruments valuation.

'Reconciling' an account means ensuring and documenting that an account balance is correct.

1 2 3 4

LOAN GRANTING.

The Lending Team:
Structures, negotiates, and implements the loans that are a pillar of the ESM's financial assistance programmes to beneficiary Member States.

Trade validation.

The Middle Office:
- Participates in the drafting process of lending documentation (request for funds, acceptance and confirmation notices).
- Maintains IT core financial data to ensure loan details are correct.
- Verifies that the loan details are correctly recorded in the system in a timely manner.

Trade matching.

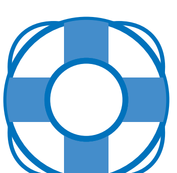
The Back Office:
- Executes disbursements in compliance with the lending documentation.

Post-trade activities.

The Back Office:
- Monitors in- and outflows to and from beneficiary Member States.
- Performs cash and securities reconciliation.

The Middle Office:
- Produces invoices for all the countries under a financial assistance programme.

LENDING



Lending activities

CYPRUS

In 2014, there were three disbursements under the Cypriot facility. The ESM signed a Financial Assistance Facility Agreement with Cyprus on 8 May 2013, which included a Loan Facility for a total of up to €10 billion, including an IMF contribution. This contribution was fixed at €8.97 billion, after the IMF decided to grant financial assistance to Cyprus of 891 million in special drawing rights (SDR). The loans to Cyprus will have a maximum maturity of 20 years and a maximum average maturity of 15 years. At year-end 2014, the weighted average maturity stood at 14.88 years.

In 2014, there were three disbursements totalling €1.1 billion. The first took place on 4 April 2014 for €150 million, followed by a €600 million disbursement on 9 July 2014. The final 2014 disbursement took place on 15 December 2014 with €350 million disbursed.

The Cypriot facility has up to €3.27 billion available for disbursement until the end of the availability period.

Table 1. Funds disbursed to Cyprus in 2013–2014

Tranche	Value date	Maturity	Loan amount (€)	Type
Tranche 1	13/05/2013	13/05/2026	1,000,000,000	
	13/05/2013	13/05/2027	1,000,000,000	
	26/06/2013	26/06/2028	1,000,000,000	
Tranche 2	27/09/2013	27/09/2029	750,000,000	Bank Recap
	27/09/2013	27/09/2030	750,000,000	Bank Recap
Tranche 3	19/12/2013	19/12/2019	100,000,000	
Tranche 4	04/04/2014	04/04/2030	150,000,000	
Tranche 5	09/07/2014	09/07/2031	600,000,000	
Tranche 6	15/12/2014	15/12/2025	350,000,000	

Source: ESM

SPAIN

The Financial Assistance Facility Agreement provided to Spain, which was signed in November 2012, consisted of a Financial Institution Recapitalisation Facility for €100 billion, with a maximum maturity of 15 years and a maximum average maturity of 12.5 years. At year-end 2014, the weighted average maturity stood at 12.49 years.

During 2012, the first disbursement under the first tranche was paid out through the delivery of ESM bonds in an amount of €39.47 billion. The ESM provided the bonds to the Bank of Spain, which received them on behalf of the Kingdom of Spain, and subsequently transferred them to the Fund for Orderly Bank Restructuring (FROB). The FROB used them to recapitalise the four financial institutions it had taken over (Group 1 banks) as well as the Spanish asset management company Sareb (Tables 2 and 3).

Table 2. Funds requested by Spain for Group 1 Banks

Tranche	Value date	Maturity	Loan amount (€)	Type
Tranche 1	11/12/2012	11/12/2022	6,578,000,000	Bank Recap
	11/12/2012	11/12/2023	6,578,000,000	Bank Recap
	11/12/2012	11/12/2024	6,578,000,000	Bank Recap
	11/12/2012	11/12/2025	6,578,000,000	Bank Recap
	11/12/2012	11/12/2026	6,578,000,000	Bank Recap
	11/12/2012	11/12/2027	6,578,000,000	Bank Recap

Source: ESM

Yanis Varoufakis
Greece

"The pioneers of Europe's monetary union understood well the need for a common fund that would stabilise the union in times of crisis and which would complement the European Central Bank's efforts at maintaining monetary stability. The European Stability Mechanism evolved precisely in this vein and for this purpose."

Table 3. Split of the funds requested by Spain for Group 1 banks and Sareb

Institution	Loan amount (€)
BFA-Bankia	17,959,000,000
Catalunya Caixa	9,084,000,000
NCG Banco	5,425,000,000
Banco de Valencia	4,500,000,000
Sareb	2,500,000,000

Source: ESM

The second disbursement of €1.87 billion was made on 5 February 2013, again through the delivery of ESM bonds, in a procedure similar to the one described above. The funds were used to recapitalise four additional Spanish banks, which could not reach the required capital levels through other means (Group 2 banks; Tables 4 and 5).

Table 4. Funds requested by Spain for Group 2 banks

Tranche	Value Date	Maturity	Loan amount (€)	Type
Tranche 2	05/02/2013	11/12/2024	932,500,000	Bank Recap
	05/02/2013	11/12/2025	932,500,000	Bank Recap

Source: ESM

Table 5. Split of the funds requested by Spain for Group 2 banks

Institution	Loan amount (€)
Banco Mare Nostrum	730,000,000
Banco Ceiss	604,000,000
Caja 3	407,000,000
Liberbank	124,000,000

Source: ESM

At the end of 2013 the availability period of the Spanish facility came to an end, which meant that the undrawn amount of €58.67 billion was automatically cancelled.

Luis de Guindos Jurado
Spain

It has been a privilege to participate in the setting up of the European Stability Mechanism. Along with the Banking Union, the ESM was a key element of the response to the crisis, providing a backstop for the euro area. In Spain, the successful implementation of the ESM financial sector programme and the ambitious reform effort have been essential to address the problems in some parts of its banking sector, which in turn was necessary to get back to growth and job creation.

PREPAYMENTS

Following a partial disposal of FROB's shares in Bankia earlier in the year, Spain proposed in June 2014 to reduce its outstanding ESM loan accordingly, via a voluntary prepayment of €1.3 billion. The ESM Board of Directors approved Spain's request on 7 July 2014 with a prepayment value date of 8 July. Spain made the prepayment in cash, rather than in ESM securities. This was the first time an ESM/EFSF programme country made an early repayment, sending a positive market signal about the success of Spain's ESM programme and the overall attractiveness of the Spanish economy. Given the amount and the timing of the operation, this payment ahead of schedule was not detrimental for the ESM.

Subsequently, on 23 July, Spain made another repayment of €307.54 million. It was related to the unused bank recapitalisation instruments, which, according to the terms of the facility, must be returned to the ESM upon expiration of the availability period. These funds constitute a scheduled repayment. Within the first tranche to Spain, €2.5 billion was initially expected to be used by FROB to capitalise Sareb, but the final amount totalled only €2.19 billion. Consequently, FROB had €307.54 million of unused funds which were subject to a scheduled repayment procedure foreseen in the 5 December 2013 acceptance notice. In particular, the acceptance notice stipulated that any ESM securities delivered to FROB but not used "on or by 15 July 2014" should be returned to the ESM, reducing the outstanding amount equal to the nominal principal amount of such ESM securities. Since the relevant ESM securities matured in February 2013 and were 'rolled over' into pool funding, the repayment was made in cash.

Following the two repayments, the outstanding amount of the Spanish facility at year-end 2014 was €39.72 billion. This outstanding amount was further reduced in March 2015, following Spain's second voluntary prepayment of €1.5 billion.

HOW THE COST OF FUNDING IS CALCULATED

The EFSF and ESM lending rates aim to fully cover their funding and operational costs as well as to reflect the varying risk profiles of each instrument. This approach has evolved over time. Early on, in 2011, the EFSF used a back-to-back funding/lending strategy, matching the funds raised from bill and bond sales to a particular beneficiary Member State's disbursement schedule. Later, to ensure greater funding efficiency and regular market access, both the EFSF and ESM adopted a different strategy, using a variety of funding instruments and different maturities. Under this new diversified funding strategy, the funds raised were no longer attributed to a particular country; instead, they were pooled and disbursed to programme countries as required.

There are still exceptions to this strategy. To recapitalise banks and finance potential resolution costs, for instance, loans are made via the delivery of EFSF or ESM notes, termed 'in kind' disbursements.

The EFSF and ESM fully transfer their cost of funding to the beneficiary Member State.[6] Additionally, their final lending rates also include small fees to cover operational costs and a margin to cover credit risk. So, while the type of loans used and the market conditions at the start of the programme may result in some initial differences in the costs of funding to beneficiary Member States, over time, as the type of loans becomes more uniform, the costs of funding tend to converge.

IRELAND AND PORTUGAL

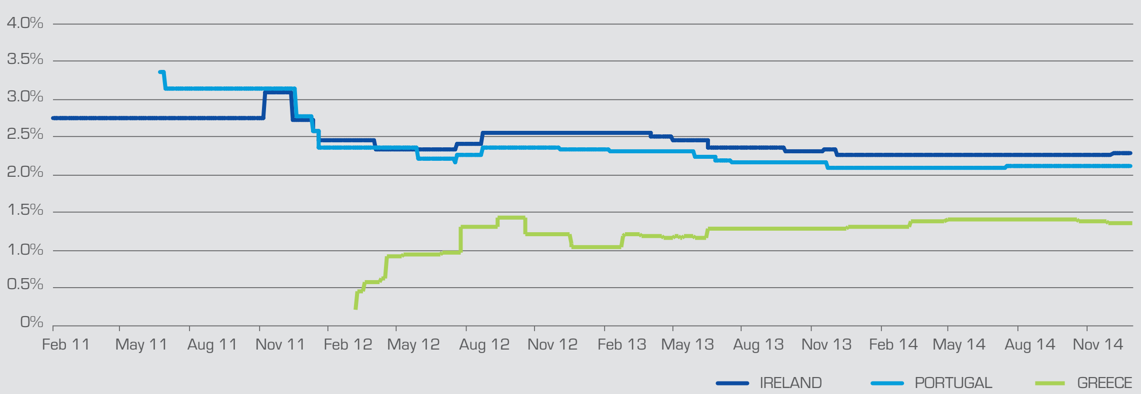
At the beginning of EFSF activity, loans were financed through fixed-rate bond issuances on a back-to-back basis.

These loans were more expensive, given a higher interest rate environment at the time, substantially higher margins charged to borrowers, and the fact that the EFSF was a new issuer in the market. From 2012 to 2014, the average funding cost of these fixed-rate bonds was 285 basis points for Irish loans and 286 basis points for Portuguese loans.

From December 2011, after the approval of the Diversified Funding Strategy, the EFSF progressively moved to pool-funded loans, which were initially financed by short-term bills.

EFSF'S COST OF FUNDING

Figure 15. Historical blended lending rates for the EFSF



Note: The first EFSF loan was signed with Ireland, followed by Portugal and Greece.
Source: ESM

6 This transfer or 'pass-through mechanism' is based on a daily computation of the actual interests accrued on all EFSF and ESM funding instruments. In the general case of disbursements sourced from the pool, the accrued interests are allocated to each disbursement on the basis of the outstanding amounts. In the exceptional cases of disbursements sourced from back-to-back funding, like those made in the first EFSF programmes or when disbursements were made in kind, the daily allocation of interests only takes into consideration the funding instrument used.

Then, the pool itself gradually moved to longer-dated debt from bills, which should have created a gradual upward movement in the cost of funding from 2012 until the present day. But this upward movement occurred only in 2012. From the beginning of 2013 it stopped, mainly because interest rates had decreased and the spread of EFSF to German bunds had narrowed.

GREECE

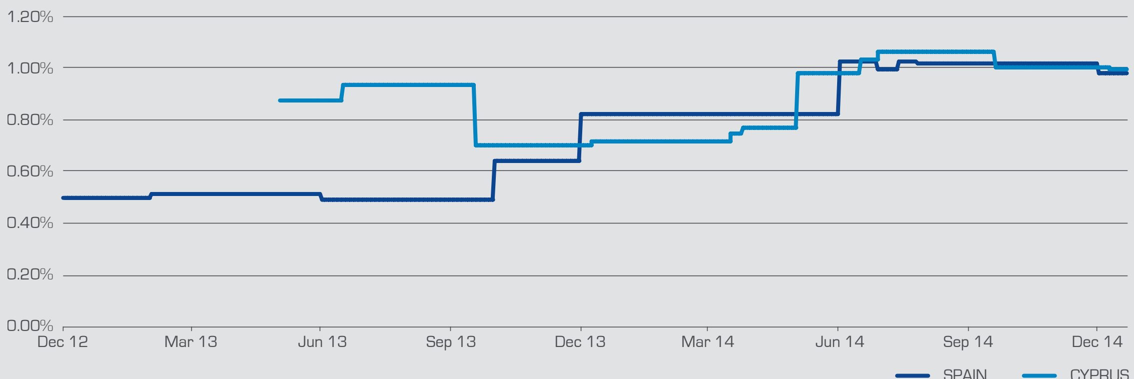
For Greece, the dynamics are different, as Figure 15 shows. Initially, Greece was mainly financed by disbursements in kind, indexed on the six-month Euribor rate (87% of the initial disbursement). Therefore, the rates started relatively low and gradually moved upwards until November 2012 as the PSI-related loans initially disbursed in kind were partly rolled into the pool, and new pool-funded loans were disbursed. The Eurogroup decided in late 2012 to defer Greece's interest payment until December 2022 and cancelled the initial guarantee commission fees of 10 basis points.

Nevertheless, the rates remain significantly lower than those of Ireland and Portugal, mostly due to the funding structure: some loans for bank recapitalisation to Greece continued to be financed in kind whereas loans to Ireland and Portugal are only pool funded by fixed-rate longer-duration funding instruments.

Starting from January 2013, the upward movements are explained by the rollover of the back-to-back loans to the pool.

ESM'S COST OF FUNDING

Figure 16. Historical blended lending rates for the ESM



Note: The first ESM programme was signed by Spain, followed by Cyprus.
Source: ESM

SPAIN

Initially, the ESM absorbed the EFSF bills programme and only provided financing on a short-term basis. The ESM thus granted the first loans through disbursements using short-term paper designed to boost banks' capital and cover resolution costs. This explains why Spain obtained such low rates at the beginning. From the end of 2013, the ESM started issuing longer-term paper, which, together with the rollover to the pool of loans initially disbursed in kind, explains the increase in the Spanish lending rate.

CYPRUS

Until September 2013, the ESM relied principally on pool-funded loans to finance Cyprus. For the same period, all Spanish loans were provided instead as in kind loans of ESM-issued notes. Thus, for the period until September–December 2013, there was a gap in funding rates between Cyprus and Spain.

After the disbursement in kind of the bank recapitalisation loan, Cypriot rates responded to the lower cost by falling 20 basis points. Then, lending rates started converging and increasing as the ESM issued longer-term paper, more pool-funded Cypriot loans were disbursed, and a large amount of Spanish loans disbursed in kind gradually moved to pool-funded loans.

Funding activities

OVERVIEW OF ESM FUNDING IN 2014

To finance the loans made to beneficiary Member States, the ESM raises funds on the debt capital markets by issuing bills and bonds. A portion of the funds raised are pooled and then disbursed to the beneficiaries at the same rate. The ESM raises funds in both long-term markets through bond issuance and in short-term markets through bill issuance. The ESM's objective is clear: to raise the required funds at the lowest possible rates.

LONG-TERM FUNDING

The ESM, which launched funding in the long-term markets in October 2013 with an inaugural 5-year bond, had a long-term funding target of €15 billion in 2014. The ESM successfully achieved this target through the issuance of bonds in different maturities, creating new reference points along its yield curve. The ESM launched three new bonds in 2014:

- 7-year bond with a 1.375% coupon issued on 4 March which raised €6 billion;
- 5-year bond with a 0.875% coupon issued on 7 May which raised €3 billion;
- 2-year bond with a 0% coupon issued on 28 October which raised €4 billion.

The ESM raised the remaining €2 billion by re-opening existing bonds ('taps'), selling the debt at the current market price but maintaining the original face value, maturity and coupon rate. For the first time, it used the auction system for that purpose, a standard process for sovereign bonds. The ESM uses the ESM Bidding System of the Deutsche Bundesbank (EBS) for all bond and bill auctions.

The first tap reopened the 10-year bond initially issued in November 2013, raising €990.75 million and bringing this bond's total size to almost €4 billion. The second tap reopened the 2-year bond initially issued in October 2014, raising €987.5 million and bringing its total size to almost €5 billion.

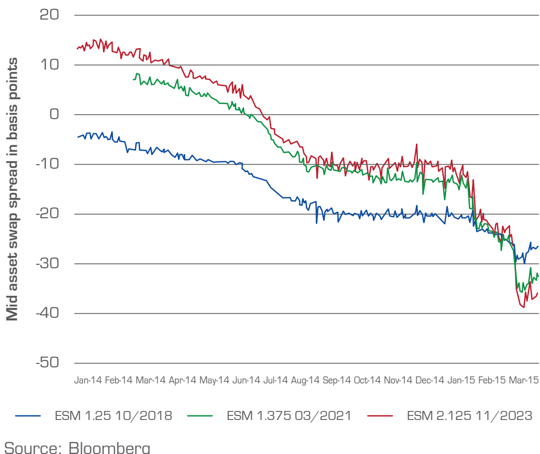
By reopening these bonds and increasing their size, the ESM provided additional liquidity to these bonds and enhanced investors' ability to trade in the secondary market.

ESM BOND PERFORMANCE

2014 was the first full year that the ESM was active in the capital markets. During the year, the ESM focused on completing its outstanding curve. In 2014, all ESM bonds performed strongly both in terms of yield and spreads to interest rate swaps.

The compression of swap spreads continued throughout the year and illustrated investor confidence in the ESM name. The ESM has now become a well-established issuer on the debt capital markets.

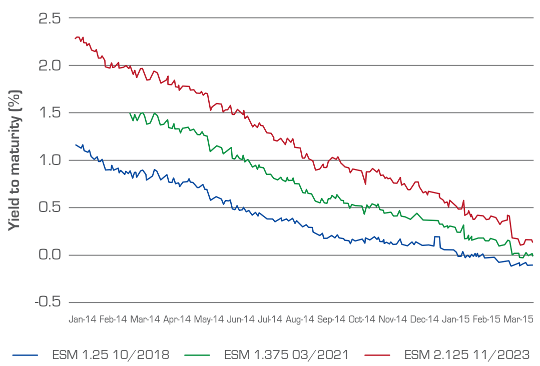
Figure 17. Spread performance of ESM benchmarks



Source: Bloomberg

In absolute terms, ESM bond yields fell across the yield curve over the year. This absolute yield decline helps beneficiary Member States going forward, because it lowers the ESM's funding costs which translates into lower interest rates for beneficiary Member States repaying ESM loans.

Figure 18. Yields of ESM benchmarks



Source: Bloomberg

ESM PLACES FIRST 2-YEAR BOND

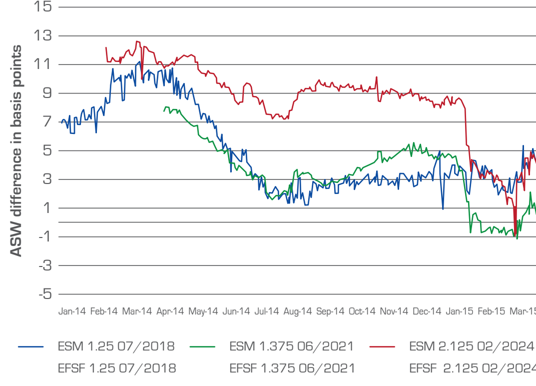
On 21 October, the ESM raised €4 billion by placing its first 2-year bond. This bond represented a new point on the yield curve for the ESM and was the first ESM bond issued with a zero coupon. Although a more unusual maturity, the 2-year bond took advantage of the market environment. It also allowed the ESM to optimise its redemption profile, enabling it to be regularly present in the market, and to offer investors the opportunity to roll over their investments. The issue attracted very strong demand, with high-quality investors such as central banks and bank treasuries placing orders for more than €5.8 billion. Given the high initial demand, the ESM reopened the bond on 25 November, bringing the total size to almost €5 billion.

2014 was also the first full year in which both the ESM and EFSF were active in the market in parallel. The risk premium for the ESM had initially been lower than that of the EFSF reflecting, among other things, the ESM's strong capital structure as opposed to the EFSF's guarantee structure. The rating agencies also expressed their views on the differing risk profiles of the two, assigning the ESM a higher rating than the EFSF.

The risk premium between the EFSF and the ESM diminished, however, over 2014, driven principally by the ECB's new monetary policy measures to support inflation and growth. In early 2015, spreads moved markedly on expectations of the ECB's expanded asset purchase programme. With more liquid bonds outstanding, the EFSF thus outperformed the ESM; markets now value both entities similarly. The exception has been the shorter bonds, such as the 2018 bond, as the EFSF and ESM were already priced in line and touching negative yields in 2015.

The performance and the current levels of yields and spreads of both the ESM and EFSF show that both issuers are well established and recognised in the markets.

Figure 19. Asset-swap spread difference between EFSF and ESM bonds



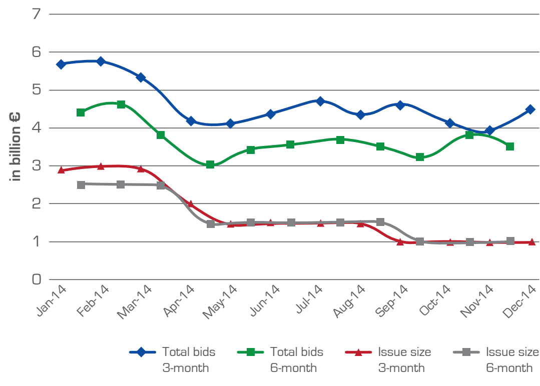
Source: Bloomberg

SHORT-TERM FUNDING

The ESM continued its short-term funding programme in 2014 with its regular 3-month and 6-month bill auctions. In total, the ESM raised over €38.5 billion in bills, with each auction raising from €1 billion to €3 billion.

The demand for bills remained strong in 2014, despite lower issue sizes in the second half of the year. This led the bid-to-cover ratio, which rises as debt demand strengthens, for the 3-month maturity to trend higher over the year, rising to 4.5 towards year-end from an early two, making the 2014 average more than three. Demand for the 6-month tenor also heightened during the year, with bid-to-cover ratios climbing to four from 1.5 for a 2.5 average in 2014. Total bids averaged €4.6 billion for the 3-month tenor and €3.7 billion for the 6-month tenor.

Figure 20. ESM bill auctions: demand and amounts raised



Source: ESM

Michel Sapin
France

> After just two years in existence, the ESM has proved a crucial and relevant partner towards our common objective for a more stable and resilient euro zone, thanks to the dedication and expertise of its staff. I am confident that, as the peak of the crisis recedes, the ESM will continue to play a pivotal role as a tool of solidarity and financial stability in tackling forthcoming challenges with the same spirit of service.

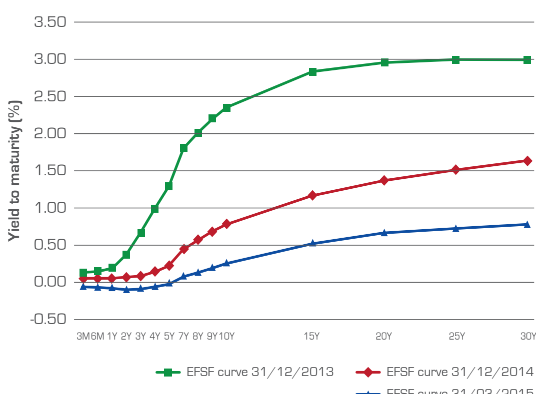
OVERVIEW OF EFSF FUNDING IN 2014

The ESM is also responsible for raising EFSF funding, which was used for the disbursements of the Greek and Portuguese programmes and the rollover of the existing debt. In 2014, EFSF raised €34.5 billion, covering a wide range of maturities from a 364-day bond which raised €4 billion in July, followed two weeks later by a 30-year bond at the very long end of the yield curve.

EFSF BOND PERFORMANCE

EFSF bonds also performed strongly in 2014. This was particularly noticeable at the long end of the yield curve. For a 30-year bond, for example, yields have fallen almost 1.5% since the end of 2013. The trend of falling yields continued into 2015.

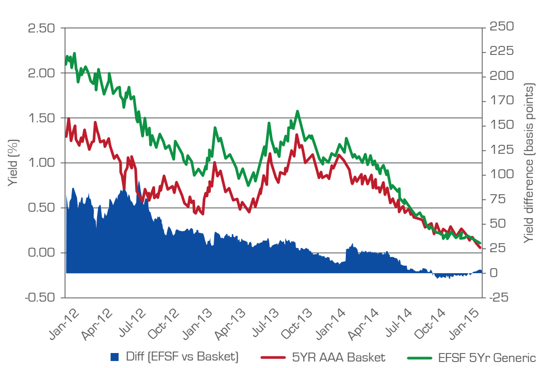
Figure 21. Interpolated EFSF curve



Source: Bloomberg

EFSF issuances are fully guaranteed through the over-guarantee structure. Comparing EFSF performance with a synthetic average yield basket of six highly-rated guarantors demonstrates that the EFSF has performed well over the last two years. The spread performance also reveals that the market now recognises the EFSF as a well-established issuer.

Figure 22. EFSF vs. core guarantors* – 5-year yield levels



Note: *Austria, Finland, France, Germany, Luxembourg, and the Netherlands.

Source: ESM

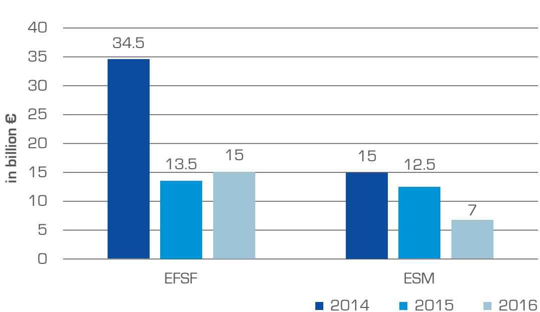
EFSF PLACES FIRST 30-YEAR BOND

On 22 July 2014, the EFSF placed a 30-year bond, the first such maturity it has issued, for a total of €4 billion. This bond matches well with the EFSF's underlying long-term loans. It allowed the issuer to lock in a historically low yield of 2.392% and, at €4 billion, represented an exceptionally large size for a supranational issuer. It attracted very strong demand with orders of over €6.1 billion and drew a number of investors to the EFSF name for the first time. The debt market industry awarded it the 'Deal of the Year' in the Euro-supranational category of the Global Capital Awards©.

FUNDING OUTLOOK 2015

The ESM announced its 2015 long-term funding target of €14 billion at end-December 2014. Due to Spain's early repayment of €1.5 billion, which the ESM Board of Directors approved on 9 March 2015, the long-term funding target was revised downwards by €1.5 billion to €12.5 billion.

Figure 23. EFSF and ESM funding programmes 2014–2016



Note: Future figures are based on estimates and may vary depending on market conditions. These figures do not include any cashless operations. The bill programme will cover shortfalls between lending requirements and long-term funding.

Source: ESM

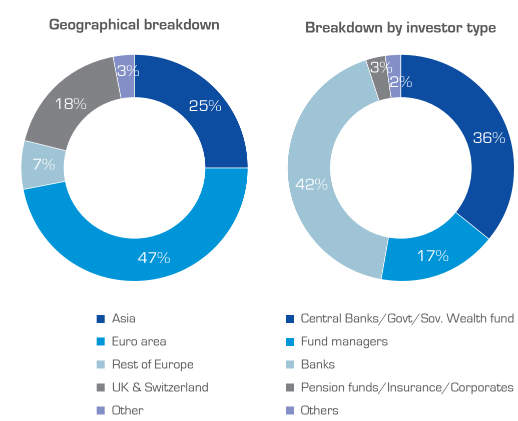
In the first quarter of 2015, the ESM raised €3 billion through the issuance of a 2.5-year bond. The bond attracted exceptional demand with an order book of over €9 billion. It was issued with a yield of -0.07% and therefore became the first Sovereign, Supranational and Agency issuer to place a euro-denominated syndicated benchmark bond at negative rates.

For the EFSF, the 2015 long-term funding target is €13.5 billion.

INVESTOR RELATIONS

Since its inaugural bond issue in October 2013, the ESM has built its investor pool and now counts upon a well-diversified and consistent base. As the ESM added points to its yield curve in 2014, it continued to attract new investors worldwide.

Figure 24. ESM investor breakdown



Note: Total breakdown includes all ESM syndicated bond issues at time of issue. Placements by auction are not included. As at 10 March 2015.

Source: ESM

A COMPREHENSIVE COMMUNICATION STRATEGY

One of the cornerstones of the Investor Relations strategy has been a clear and transparent communication policy. The quarterly newsletter outlines the funding programme for the coming quarter. It provides the dates for the 3-month and 6-month bill auctions. For the bonds, it is still important to retain some flexibility to adapt to changing market conditions; therefore, the newsletter identifies the weeks where the EFSF or ESM could potentially come to the market with a transaction. The newsletter also details the amounts the EFSF and ESM will raise in each quarter.

This enables investors to be fully aware of the amounts that the EFSF and ESM have to raise per quarter and indicates clearly when the EFSF and ESM will be coming to the market to issue a bond.

Subscription to the ESM newsletter can be made via the Investor Relations section of the ESM website at: **http://www.esm.europa.eu/investors/subscribe-newsletter.htm.**

ESM ENJOYS ROBUST CREDIT RATINGS

The ESM is committed to maintaining a high credit rating to successfully fulfil its mandate. Throughout 2014, it continued to rank among the international financial institutions with the highest creditworthiness. Fitch Ratings has assigned it a long-term AAA rating with a stable outlook and a short-term rating of F1+. In June 2014, Moody's Investors Service improved the ESM outlook on its long-term Aa1 rating to stable from negative and affirmed its short-term rating of P-1. Furthermore, in May 2014, DBRS Inc. assigned the ESM unsolicited long-term and short-term issuer ratings of AAA and R-1 (high) with a stable trend.

The ESM's high credit rating derives from the institution's standalone credit strengths. The following key elements are emphasised:

- The ESM has a large capital base, which compares favourably with those of its peers, given total paid-in capital of €80 billion and total subscribed capital of €704.8 billion, as of 18 March 2015. Its relatively low leverage would be preserved even if the ESM used its maximum lending capacity of €500 billion;

- The ESM has a unique capital call mechanism, which allows the Managing Director to call capital to avoid a default on obligations, without requiring additional approval from the Board of Directors or the Board of Governors. On a subscribed capital basis, ESM Members have overall a high average creditworthiness, in line with AAA-rated institutions;

- The ESM's risk management guidelines are prudent, in particular as regards the investment of the paid-in capital portfolios and liquidity management;

- The ESM's Early Warning System, entailing reviews of the financial conditions of the beneficiary Member States well in advance of scheduled repayments, and the ESM's preferred creditor status, are robust credit-enhancing factors.

In addition to credit agencies' views, the regulatory treatment of ESM debt is also important for maintaining its diversified investor base. In this regard, the Basel Committee on Banking Supervision has agreed that supervisors may allow banks to apply a 0% risk weight to claims on the ESM. Furthermore, together with other assets of the highest liquidity, ESM debt is also included among level 1 assets for the calculation of the liquidity coverage ratio as classified by the delegated act on the liquidity coverage ratio that defines the eligible assets and their treatment for EU banks' liquidity buffers.[7]

7 Liquidity coverage ratio rules for EU banks are described in EU Regulation 575/2013 (Capital Requirements Regulation).

Investment and Treasury

INVESTMENT POLICY

The Investment Policy ensures that the investment of the paid-in capital is implemented in an efficient and conservative manner. By preserving the paid-in capital, the policy makes sure that the ESM maximum lending capacity remains available at all times.

The ESM Guideline on Investment Policy, approved by the Board of Directors, defines the overall framework within which the ESM carries out investment and treasury activities.

Investment and Treasury decisions are overseen by an Investment Management Committee (IMC) chaired by the Chief Financial Officer. The Internal Risk Committee (IRC), chaired by the Chief Risk Officer, ensures that all investments conform to the ESM Risk Policy.

The Managing Director is responsible for implementing the investment policy in accordance with the Guideline on Investment Policy and also for setting up the appropriate governance framework.

INVESTMENT STRATEGY

In 2014, in a context of modest economic growth and very low inflation rates, yields in European bond markets fell to historically low levels, as monetary policies remained extremely accommodative in major markets. In Europe, in particular, the aggressive monetary policy decisions taken by the ECB (cuts of the deposit facility rate to minus 0.20%, Long Term Refinancing Operations and additional purchase programmes) propelled short-term European interest rates to negative levels.

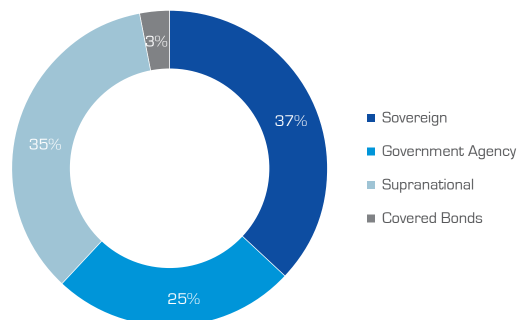
To reduce the impact of the negative yields on the paid-in capital, which is divided into a Short Term Tranche (STT) and a Medium/Long-Term Tranche (MLTT), the size of the STT was progressively reduced in 2014 in favour of the MLTT. The STT reached its minimum size of €5 billion, which is considered large enough in the current market environment to provide the ESM with an appropriate level of liquidity. The latter is also ensured by the overall Investment Policy which strongly favours investment in high-quality liquid assets.

The fall in short-term yields pushed the rest of the yield curve to a historically low level: the German government 5-year and 10-year bond yields fell, respectively, by 90 and 140 basis points over the year. In that context, the ESM's investment strategy for the MLTT continued to focus on the most appropriate way to achieve capital preservation over a 3-year horizon. This led the ESM to prefer investment in highly-rated assets at positive yields, and to move to longer-dated debt toward the higher boundary of the target range (see the box on 'Negative yields present new challenge to safeguarding capital'). The portfolio's curve exposure was designed to take advantage of carry and roll-down effects, and also to benefit from an expected flattening of the curve in a low inflation environment.

As the continuous fall in yields led investors to look for alternative investment opportunities, credit spreads narrowed across markets. On average, in the 10-year sector, the credit spread of supranational and European government agency issuers contracted by 25 to 30 basis points against Germany, which supported the performance of ESM paid-in capital invested in this type of assets (see Figure 25).

Overall, the ESM benefited from this investment strategy which enabled the paid-in capital portfolio to outperform its investment benchmark, a mix of 0/1-year and 1/3-year indices of highly rated European bonds.

Figure 25. ESM paid-in capital investment securities breakdown, by asset class



Note: Breakdown as of 31 December 2014.

Source: ESM

Pier Carlo Padoan
Italy

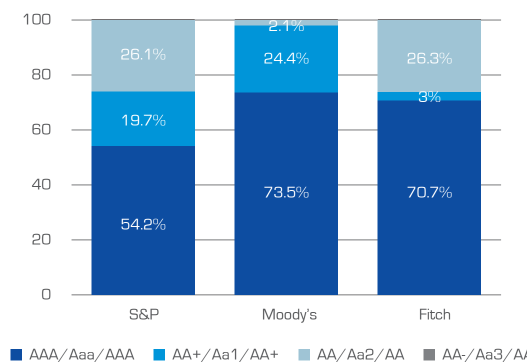
During the crisis, the ESM's lending activities together with its fund-raising capacity have reassured investors and contributed to improve conditions in financial markets. Over the years, ESM strengthened its organisation and introduced new instruments like the direct recapitalisation of banks. A stronger and evolving institution is key to further enhance financial stability in the euro area.

INVESTMENT STRUCTURE

The last €16 billion instalment of paid-in capital was received in April 2014. With this payment, the total paid-in capital reached its target size of €80 billion. The investment occurred in a near zero but positive yield environment for maturities up to two years. The additional capital was invested, in accordance with the investment guidelines, across the curve and with a three-month ramp-up period ending in July.

The paid-in capital (PIC) is invested in high-quality assets as illustrated by the rating distribution. At the end of 2014, and depending on the rating agencies' methodologies, 73.7% to 97.9% of the PIC portfolio was invested in securities with a rating equal to or above AA+, with the rest of the assets rated AA/AA- (see Figure 26).

Figure 26. Rating distribution of the paid-in capital securities, by rating agency



Note: Distribution as of 31 December 2014.
Source: ESM

Within this high-quality universe, the exposures of the ESM's portfolios are diversified across asset classes. At the end of 2014, ESM assets were relatively well balanced with a mix of Sovereign, Supranational, and Government agency exposure. AAA Covered Bonds have also contributed to the diversification but remain, at this stage, a minor exposure for the ESM at 3% of the total PIC.

NEGATIVE YIELDS PRESENT NEW CHALLENGE TO SAFEGUARDING CAPITAL

Holding assets at negative yields represents a cost, as the expected return over the remaining life of the security is negative. For the ESM's PIC, whose assets were bought at positive yields, this situation will over time decrease unrealised gains.

To reduce the impact of negative yields on the PIC's expected return – a key objective to ensure capital preservation – the ESM has initiated a range of measures:

- In 2014, duration was kept at the higher end of the duration band to increase the proportion of assets invested at positive yields.
- Since the last quarter of 2014, additional credit limits for AAA-covered bond issuers have been approved.
- Since the start of 2015, assets with deeply negative yields have been actively sold.

In 2015, additional measures could be implemented to further reduce the impact of negative yields on the PIC.

Different options such as non-euro investments are being explored. The aim would be to enable the ESM to invest in foreign currency assets and hedge back into euros so that the positions do not generate foreign exchange risk. Such non-euro hedged foreign exchange instruments, which are widely used by major central banks, could contribute to the diversification of the ESM's portfolios. It could also contribute to the ESM's capital preservation objective by enabling it to invest, when opportunities arise, at more favourable conditions than in euros over short-term horizons, while keeping risk low.

Furthermore, a possible enlargement of the investment universe will be assessed to increase opportunities without affecting the ESM's overall financial strength.

Risk management

The ESM has clear risk management objectives and an established strategy to deliver them through appropriate governance and core risk management processes. The organisation's approach to risk management derives from the ESM Treaty and the 'High Level Principles for Risk Management', both documents being publicly available.

The ESM's risk management objectives are stated in the High Level Principles, and in summary are:

- follow a prudent approach to risk-taking in order to limit potential losses and ensure continuity in fulfilling the ESM's mandate and meeting its commitments;
- maintain minimum capital requirements in order to ensure the highest creditworthiness and to avoid unexpected capital calls;
- preserve the ESM's funding, and hence lending, capacity.

The ESM applies elements of its risk management framework to all aspects of its mandate, with the exception of accepting counterparty risk on financial assistance granted to ESM Members experiencing severe financial problems, where such assistance is indispensable to safeguard the financial stability of the euro area as a whole and of its Member States. Although the ESM aims to fully cover its financing and operating costs, the ESM does not aim to generate profit on financial support granted to beneficiary Member States and does not provide incentives for speculative exposures of its investment portfolio.

RISK GOVERNANCE

The Board of Governors delegates authority and accountability to the Board of Directors for establishing the ESM risk management framework and to the Managing Director for implementing it. The ESM has also established two risk committees:

- the **Board Risk Committee,** a permanent committee of the Board of Directors, advising it on the overall current and future risk appetite, and assisting it in reviewing and overseeing the development of the ESM's risk management framework;
- the **Internal Risk Committee,** a permanent internal ESM committee, comprising the Management Board and Chief Risk Officer, which evaluates, monitors and approves practices regarding the implementation of the ESM's risk management framework.

Risk management responsibilities within the ESM are established on the 'Three Lines of Defence' concept, which sets out clearly drawn lines of authority and appropriate segregation of powers and duties. The ***first line of defence*** consists of business functions and departments with direct responsibility for the day-to-day management of risk. The ***second line of defence*** is performed by an independent risk management function, led by the Chief Risk Officer, which oversees the risks assumed by the business and ensures they are appropriately managed and controlled. The ***third line of defence*** consists of an independent internal audit function, led by the Internal Auditor, responsible for providing the Board of Directors with assurance that risk management controls are operating properly and efficiently. Both the Chief Risk Officer and Internal Auditor report directly to the Managing Director to ensure their independence.

RISK APPETITE

ESM Risk Policy documents the appetite for risk that the ESM Board of Directors is willing to accept in the execution of the organisation's mandate. The ESM management and Risk department cascade this risk appetite into relevant aspects of governance, policies, frameworks, and individual limits to ensure that the organisation's activities remain within this risk appetite. In addition, internal statements have been drafted, defining the tolerance for specific material risks that the ESM itself can manage and mitigate.

RISK CULTURE

Establishing a strong risk culture is of paramount importance to the ESM. Risk culture is the combined set of individual and corporate values, attitudes, competencies and behaviours that determine the ESM's commitment to the management of risk at all levels. Supported by management, risk culture in the ESM is founded on a close alignment between the organisation's objectives and the risk management framework. Such a culture embeds an independent discipline, which in turn ensures rigorous challenge and objectivity in decision-making.

RISK MANAGEMENT PROCESS

The ESM has implemented a systematic four-step process to manage the various types of financial and non-financial risk to which the organisation is exposed.

Risk identification – the identification of all material risk exposures, both financial (credit, market and liquidity risk) and non-financial.

Risk assessment and measurement – the assessment of identified risk exposures to determine their materiality, based on a combination of quantitative tools and expert judgement.

Risk monitoring and control – the on-going monitoring and control of material risk exposures, including limit frameworks, key risk indicators, reporting and escalation.

Risk management – the process of determining and executing appropriate actions to actively manage risk exposures, such as mitigation, transfer, reduction, or acceptance of the risk.

NATURE OF ESM ACTIVITIES AND KEY RISKS

The ESM is an intergovernmental, non-commercial entity, established to support the stability of the euro area and euro area Member States. To fulfil this mandate, the ESM needs to maintain the highest creditworthiness so as both to minimise the cost of borrowing and thus support lending operations and to ensure market access. To achieve this aim, risk management policies and the Investment Policy are formulated prudently and conservatively.

Nevertheless, as with all financial institutions, the ESM remains subject to a number of financial and non-financial risks. These risks are a function of the ESM's mandate and operational activities, as well as its operating model and financial policies. The ESM therefore implements the appropriate procedures and processes to identify, assess, measure, monitor, and manage these risks.

FINANCIAL RISKS

CREDIT RISK

Credit risk – the risk of loss arising from the inability of a counterparty, issuer, insurer, or other obligor to fulfil its contractual obligations. The ESM is exposed to credit risk from two sources: lending and stability support activities; and investment and funding operations.

Lending and stability support activities

Credit risk from lending – the risk of loss if Member States which have benefited from the ESM's financial stability support fail to fulfil their contractual obligations.

- Lending by the ESM is protected by **preferred creditor status**, junior only to the IMF, which is a strong measure mitigating the credit risk from lending.
- As part of its **Early Warning System**, the ESM assesses the ability of a beneficiary Member State to repay its obligations. Findings are summarised in a regular report which is considered by the Internal Risk Committee. This activity is in accordance with the mechanism for drawing down callable capital if required (see the publicly available Terms and conditions of capital calls for ESM).

Credit risk from Direct Recapitalisation Instrument – the risk of loss if there is a default by a financial institution on direct capital assistance in the form of equity and junior debt.

Investment and funding operations

Issuer and counterparty risk – the risk of loss as a result of the non-fulfilment of contractual obligations.

Credit concentration risk – the risk of loss due to investments being too heavily concentrated in a particular issuer, class of issuer, sector, country, or similar category, and therefore being exposed to the risk that issuer and counterparty risk losses could be highly correlated.

The ESM is primarily exposed to these risks through its need to invest proceeds from its paid-in capital, the liquidity buffer and the reserve fund.

Credit limits and minimum credit quality thresholds mitigate credit risk exposure. Compliance with these thresholds is analysed independently by counterparty risk specialists and checked against the ratings assigned to counterparties, issuers and individual issuances, by the three major rating agencies, namely Fitch, Standard and Poor's and Moody's. In addition, credit risk is also mitigated through the use of collateral, which is also subject to eligibility requirements and margin calls. The ESM measures and monitors credit risk exposures and compliance with credit risk rules on a daily basis.

Harris Georgiades
Cyprus

It is my firm belief that the establishment of the European Stability Mechanism has been decisive in addressing emerging challenges in the EMU, in the midst of the unprecedented global economic crisis.

It is also my belief that the ESM will remain a key institution, safeguarding the financial and economic stability of the EMU from any future crises.

MARKET RISK

Market risk – the risk of loss arising from changes in the values of financial assets and liabilities (including off-balance sheet items) due to price fluctuations in interest rates, foreign exchange and other securities. Market risk can be structural (in relation to assets and liabilities) or non-structural (in relation to investments).

The ESM has both types of market risk: structural for lending and funding activity, and non-structural for the investment of the paid-in capital.

The ESM's main market risk is **interest rate risk** – the risk of loss arising from adverse movements in market yields or the term structure of interest rates. This type of risk can manifest itself in different ways:

Structural

- **General interest rate risk** – the risk of loss due to an adverse change in the overall level of interest rates acting on the net level of interest rate exposure between assets and liabilities.
- **Refinancing risk** – the risk of loss of income arising from the differences in maturity profiles of the assets and liabilities (maturity mismatch or ALM risk) due to changes in the term structure of interest rates, i.e. steepening or flattening of the curve. Refinancing risk occurs when the maturity of assets is longer than the maturity of the liabilities used to fund them.

Non-structural

- **General interest rate risk** – the risk of loss due to an adverse change in the overall level of interest rates affecting the value of the investments. There will not be a realised profit or loss unless the investments are subsequently sold at the new interest rate level.
- **Basis risk** – the risk of loss due to an unexpected divergence in the spread between different sectors of the interest rate market used as the basis for pricing the investments, or between a derivative product and the exposure it is hedging.

Jānis Reirs
Latvia

In a situation when it is necessary to deal with exceptional financial stability problems or a situation where a Member State is threatened by possible severe financing problems, the ESM is an important element to restore stability in the euro zone. Hence, it is vital that the ESM continues to perform as successfully and productively as it has up to now.

Structural interest rate risk is controlled via cash flow projections performed by the ALM function, supported by a short-term liquidity buffer as described in the Investment Policy. The ESM is required to maintain coverage of all outflows up to one year using the liquidity buffer and part of its capital. Even though all funding costs arising from refinancing risk are currently 'passed through' to beneficiary Member States under financial assistance, as defined by the ESM Pricing Policy, the ESM measures and monitors this risk continually, since it is generally the case that long-dated assets will be funded by shorter-dated liabilities.

Non-structural interest rate risk is controlled by a series of limits on portfolio duration, monitored daily. There are also longer-term value-at-risk limits for each tranche of the paid-in capital as described in the Guideline on the Investment Policy. These are monitored by means of daily calculations, performed using a 99% confidence level, which are then converted to longer-term values and compared with risk appetite.

Value-at-risk does not measure the worst loss that could be experienced. Hence, in addition, various yield curve and market sensitivity stress tests are carried out daily, as well as periodic exercises related to economic scenarios that are reviewed by the risk committees.

The ESM recognises other market risks:

- **Credit spread risk** – the risk of loss on an investment in a debt security as a result of a decrease in the value of the security due to an actual or market-implied decrease in the creditworthiness of the issuer. Spread risk can be specific to a particular issuer as well as being driven by changes in sector, country, and other relevant spreads. This risk is controlled within the set of value-at-risk limits described above.

- **Foreign exchange risk** – the risk of loss arising from changes in the exchange rates. Since the ESM currently funds and invests only in the euro, this risk is not present. To date, the ESM has not used derivative instruments in any of its activities.

- **Equity risk** – the risk of loss arising from changes in the price of equity instruments. These instruments could arise in the context of the Direct Recapitalisation Instrument, whereby the ESM would provide capital directly to certain eligible financial institutions. At present the ESM has not provided any such capital directly, hence it holds no equity risk.

Table 6 gives a daily and annualised value-at-risk comparison between the end of 2013 and the end of 2014.

Table 6. Daily and annualised value-at-risk comparison, 2013 and 2014

	Portfolio value in € million	1 day value-at-risk in € million	Daily % of portfolio value	Annualised % of portfolio value
As at 31.12.2014	84,694	110	0.13%	2.06%
As at 31.12.2013	78,307	56	0.07%	1.13%

Source: ESM

Rimantas Šadžius
Lithuania

The European Stability Mechanism contributes to both financial stability and solidarity within the euro zone. I am proud that Lithuania is a part of it as of 2015.

LIQUIDITY RISK

Two main types of liquidity risk are faced by the ESM:

- **Funding liquidity risk** – the risk of loss arising from difficulty in securing the necessary funding, or from a significantly higher cost of funding than normal levels, due to a deterioration of the ESM's creditworthiness, or at a time of unfavourable market conditions (such as periods of high stress).

- **Liquidity concentration risk** – the risk of loss arising from concentrations in assets and liabilities as major sources of liquidity, particularly in times of market stress.

The ESM addresses these liquidity risks by holding sufficient capital at all times, invested in appropriately liquid assets, plus an adequate liquidity buffer to cover short-term liquidity needs. The liquidity buffer is managed according to two principles: it must comply with sound liquidity risk management principles; and it may not become too large compared with these risks, so as not to generate excessive cost of carry for beneficiary Member States. At the end of December 2014, the liquidity buffer stood at €3.8 billion (2013: €5.0 billion); on average in 2014 it was €9.4 billion (2013: €5.0 billion).

The ESM continually monitors funding conditions, and stresses its projections of asset and liability cash flows based on a number of alternate assumptions. The organisation further minimises liquidity risk through a diversified funding strategy. The notes to the ESM Financial Statements provide a table of liquidity gaps by maturity band, and the section covering funding in this Annual Report describes the strategy and instruments used to fulfil ESM's liquidity needs (see page 45).

There is a third type of liquidity risk, **market liquidity risk** – the risk of loss arising from a position that cannot easily be unwound or offset at short notice without significantly influencing its market price due to inadequate market depth or market disruption. This risk is present in relation to the investment of the ESM's capital, and is controlled by limits such as the total proportion of a bond issuance that can be held.

NON-FINANCIAL RISKS

The ESM is subject to a number of non-financial risks due to the nature of its activities and its mandate, which include operational risk, reputational risk, legal risk, compliance risk, and political risk. Careful vigilance in regard to all of these risks is a major priority for the ESM. Each is identified, assessed, and monitored by the relevant ESM department, with periodic oversight provided by the Internal Risk Committee and Board Risk Committee.

Operational risk is the potential loss and/or damage (such as the inability of the ESM to fulfil its mandate) resulting from inadequate or failed internal processes, people, and systems or from external events. The categorisation of the ESM operational risks is based on guidance from the Basel Committee on Banking Supervision, namely risks related to:

- execution, delivery and process management;

- counterparts, products and business practices;

Pierre Gramegna
Luxembourg

I am proud that Luxembourg is hosting the ESM, which has been an important tool for the stabilisation of the euro zone since its launch in 2012. I am convinced that the ESM will continue to play a decisive role in the further development of the Economic and Monetary Union.

SPOTLIGHT
The Finance Minister's view on the ESM

- internal and external fraud;
- business continuity and system failures;
- employment practices and workplace safety;
- damage to physical assets.

The ESM's risk appetite contains no tolerance for material operational risks and a very low tolerance for other operational risk losses. All departments ensure proactive mitigation of operational risks and robust controls in their processes. Should specific operational risk events occur, these are reported to an internal operational risk register, with follow-up conducted to address operational risk issues via the risk committees and, where necessary, the Board of Directors. A comprehensive Business Continuity Management Policy is in place to maintain a robust business continuity capability.

The above approach to operational risk management is complemented by: an annual self-assessment of the top operational risks, based on likelihood and potential impact; an annual fraud risk assessment, together with an anti-fraud and control programme; and annual scenario-based exercises related to business continuity, to ensure the prompt and efficient recovery of the business from any incident affecting the ESM's ability to maintain normal operations.

Reputational risk – the risk of loss and/or damage arising from a deterioration in the ESM's reputation, reducing its access to the market, lowering of credit rating, loss of political capital, inability to attract suitably qualified staff, and other similar consequences. This risk is managed by the ESM undertaking its mandate in accordance with the highest professional standards and prudent management of all ESM's risks, and by having centralised coordination of external communication, including permanent media monitoring, regular meetings with journalists covering the ESM, and membership of a network of European institutions maintaining an alert on reputational risks.

Legal risk – the risk of loss as a result of inadequate or inefficient documentation, legal capacity, enforceability of national and international laws; litigation against the ESM or its assets; and non-compliance with the Treaty establishing the ESM, associated By-Laws, or any other applicable laws and contractual obligations. Legal risk is managed by obtaining review and advice from internal and external legal counsel to ensure ESM activities are in compliance with the law and supported by enforceable, robust contractual arrangements.

Compliance risk – the risk of loss and/or damage associated with the non-compliance with internal policies, procedures and guidelines as well as any external policies, regulations and directives which

Edward Scicluna
Malta

The ESM is our flagship financial institution with an explicit mandate for economic and financial stability in times of need. Such stability is the cornerstone of all economic and social progress.

might govern the ESM. The Code of Conduct, as part of the ESM legal framework, defines the fundamental ethical principles to be assumed by ESM personnel, such as the requirements regarding the employee's integrity and loyalty, guidelines for handling conflicts of interest, prohibitions on insider trading, restrictions on financial interest and rules regarding information secrecy. Following the approval of the Code of Conduct in March 2014, all staff underwent training and completed certification relating to the Code of Conduct.

Compliance risk is managed by the Compliance Officer, who on behalf of the Managing Director identifies and assesses compliance risks, formulates policies in such areas as anti-money-laundering control and information barriers, and provides guidance and training to staff on compliance matters, particularly in relation to the Code of Conduct. A Compliance Charter, formulating the mandate of the Compliance function, is published on the ESM website.

Political risk – the risk of loss and/or damage arising as a result of a single or multiple political events that affect the ESM's ability to perform its mandate, for example, by reducing access to the market for funding. Political risk is managed principally by the Board of Governors and closely monitored by the Managing Director.

Communications

As a publicly funded international institution with the mandate to safeguard financial stability in the euro area, the ESM is committed to ensuring that anyone interested can understand the organisation and what it does. The ESM demonstrated this commitment in 2014 by maintaining a consistent presence in the public domain, communicating frequently with the general public and its various stakeholders in Europe and beyond.

Given ongoing public interest, the Managing Director and ESM senior staff made numerous media appearances in 2014. These helped to explain the ESM's activities, economic developments in the euro area Member States, particularly those with assistance programmes, market developments, policy decisions concerning the euro area, and the wider economic context that influences the euro area. The ESM and its Managing Director also see it as their task to explain that while more progress is needed there have been significant advances in reforming and strengthening the Economic and Monetary Union both at national and European level.

The Managing Director participates in the press conferences held at the conclusion of the monthly euro area finance ministers' meetings and visits individual euro area Member States. The Managing Director and ESM senior staff took part throughout 2014 in several meetings and conferences worldwide, attended by policy makers or academics. The speeches, presentations and video recordings of these conferences are available on the ESM's website: www.esm.europa.eu/press/index.htm.

Following an invitation from the European Parliament in 2014, the Managing Director attended meetings of the Economic and Monetary Affairs Committee. Since

Hans Jörg Schelling
Austria

Less than three years after its establishment, the ESM has become an indispensable element of the architecture of the euro area. Today, the institution has successfully proven its importance as a safety net, assisting countries in exiting financial turmoil and restoring confidence.

the ESM is not an EU institution, this participation is done on an ad hoc basis to inform and debate with the European people's representatives. At its Luxembourg headquarters, the ESM regularly accommodates visitor groups and journalists for institutional visits and presentations.

Press releases are the standard means of communication for all important news regarding the ESM. Communication of important topics, such as the 2014 introduction of the Direct Bank Recapitalisation Instrument, are sometimes complemented by a more extensive Frequently Asked Questions (FAQ) document. The use of social media underpins public communication.

The ESM Annual Report, presented to the Board of Governors at the Annual Meeting, is the organisation's reference document with an extensive description of its mandate, its activities and the economic situation of the euro area with a view to its crisis resolution and financial stability. In 2015, the ESM plans to launch a publication programme that will start to treat in-depth topics related to its mission.

As the crisis subsided in 2014, the ESM organised occasional conferences to analyse and discuss topics related to its mandate. The initial conference was held in Luxembourg in October 2014 with Jacques de Larosière, the former IMF Managing Director, speaking on 'The Future of European Banks'.

The ESM's shareholders, other stakeholders and the public can find a comprehensive and regularly updated set of relevant information, such as legal documents, financing agreements, institutional information, and programme and investor-related information on the ESM website.

03.

INSTITUTIONAL FRAMEWORK AND ORGANISATION

ESM'S FINANCIAL ASSISTANCE TOOLKIT

Primary market purchases

Objective:

the ESM may engage in primary market purchases of bonds or other debt securities issued by ESM Members at market prices to allow them to maintain or restore their relationship with the investment community and therefore reduce the risk of a failed auction. This can complement the regular loan instrument or a precautionary programme. The purchase will be limited to 50% of the final issued amount.

Conditionality:

no additional conditionality beyond the underlying programme.

UNUSED — USED

Loans within a macroeconomic adjustment programme

Objective:

to assist ESM Members in significant need of financing, but which have lost access to the markets, either because they cannot find lenders or because the financing costs would adversely impact the sustainability of public finances.

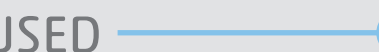
Conditionality:

ESM loans are conditional upon the implementation of macro-economic reform programmes prepared by the EC, in liaison with the ECB and, where appropriate, the IMF.

Monitoring:

the same institutions are entrusted with monitoring compliance with the agreed programme conditions for economic reform. The ESM Member is obliged to cooperate with this monitoring and enable the ESM to perform its financial due diligence. If the country deviates significantly from the programme, disbursements may be withheld.

UNUSED — USED



IRELAND
PORTUGAL
GREECE
CYPRUS

Secondary market purchases

Objective:

to support the sound functioning of the government debt markets when lacking market liquidity threatens financial stability in the context of a loan either with a macroeconomic adjustment programme or without if the Member's economic and financial situation is fundamentally sound.

Conditionality:

for ESM Members not under a programme, specific policy conditions will apply.

UNUSED — USED

Precautionary credit line

Objective:

to support sound policies and prevent crisis situations from emerging. It aims to help ESM Members whose economic conditions are sound to maintain continuous access to market financing by strengthening the credibility of their macroeconomic performance.

Two types of credit lines:

both can be drawn via a loan or a primary market purchase, have an initial availability period of one year and are renewable:

- **Precautionary Conditioned Credit Line (PCCL):** available to a Member State whose economic and financial situation is fundamentally sound, as determined by respecting six eligibility criteria such as public debt, external position or market access on reasonable terms.
- **Enhanced conditions credit line (ECCL):** access open to euro area Member States whose economic and financial situation remains sound but that do not comply with the eligibility criteria for PCCL. The ESM Member is obliged to adopt corrective measures addressing such weaknesses and avoiding future problems in respect of access to market financing.

The ESM Member has the flexibility to request funds at any time during the availability period.

Monitoring:

when an ECCL is granted or a PCCL drawn, the ESM Member is subject to enhanced surveillance by the EC. Surveillance covers the country's financial condition and its financial system.

UNUSED — USED

Loans for indirect bank recapitalisation

Objective:

to preserve the financial stability of the euro area by addressing those cases where the financial sector is primarily at the root of a crisis, rather than fiscal or structural policies.

Eligibility:

the beneficiary Member State should demonstrate an inability to:

- Meet capital shortfalls via private sector solutions.
- Recapitalise the institutions without adverse effects for its own financial stability and fiscal sustainability.

The institutions should be of systemic relevance or pose a serious threat to the financial stability of the euro area or its Member States. The ESM Member should demonstrate its ability to reimburse the loan.

Conditionality:

will apply to financial supervision, corporate governance and domestic law relating to restructuring or resolution.

Monitoring:

the EC enforces compliance with EU state aid rules and also monitors other policy conditions with the ECB and the relevant supervisory authority.

UNUSED — USED

SPAIN

Direct recapitalisation of institutions

Objective:

to help remove a serious risk of contagion from the financial sector to the sovereign by allowing the direct recapitalisation of institutions. The total amount available for this instrument is limited to €60 billion.

The instrument is relevant for banks (systemically important credit institutions), financial holding companies, and mixed financial holding companies as defined in relevant EU legislation.

Eligibility:

the relevant institutions are considered eligible if the following situations apply:

- They are or are likely to be in breach of the relevant capital requirements and are unable to attract sufficient capital from private sector sources to resolve their capital problems.
- Burden-sharing arrangements, such as bail-in (fully applicable in 2016), in the Bank Recovery and Resolution Directive, are insufficient to fully address the capital shortfall.
- They have a systemic relevance or pose a serious threat to the financial stability of the euro area as a whole or the requesting ESM Member.
- The institution is supervised by the ECB.
- The beneficiary Member State should also demonstrate that it cannot provide financial assistance to the institutions without very adverse effects on its own fiscal sustainability, and that therefore the use of the indirect recapitalisation instrument is infeasible.

Conditionality:

will apply, addressing the sources of difficulties in the financial sector and, where appropriate, the general economic situation of the ESM Member. Additional institution-specific conditions will also apply.

UNUSED — USED

ESM DEVELOPS LAST RESORT TOOL FOR BANKING UNION

The ESM completed in 2014 extensive internal preparations of more than one year for the introduction of the Direct Recapitalisation Instrument (DRI) into the ESM's financial assistance toolkit. DRI is now one element of a wider package, alongside the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), introduced to fortify the euro area's Banking Union. The DRI may be used as a last resort measure after employing other options, including the bail-in mechanism.

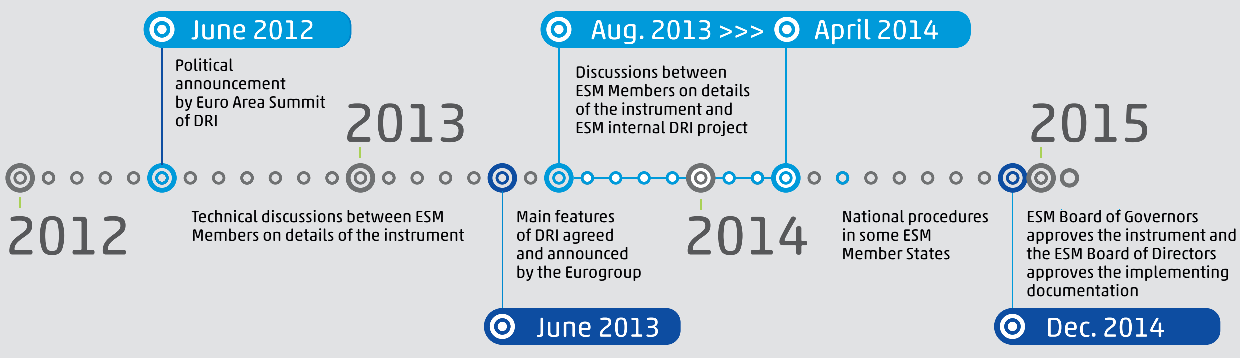
The Eurogroup, announcing the DRI in June 2012, defined its purpose as breaking the link between banks and sovereigns. Under the DRI, the ESM would provide financial assistance directly to systemically important banks in the euro area. The ESM would therefore take equity risk on its investment. The DRI would not increase the national debt of the beneficiary Member State. The use of the instrument is subject to a request by an ESM Member and requires the respect of strict conditionality relating to the beneficiary institution as well as the banking sector and/or the general economic policies of the beneficiary Member State.

The operational framework for the DRI also includes a specific provision in relation to the retroactive application of the instrument, which must be decided on a case-by-case basis and by mutual agreement.

Since its development, the likelihood of the use of the DRI has become more remote, due to the adoption of another key regulation to enhance the resilience of financial institutions. The Bank Recovery and Resolution Directive requires bail-in of a banks' creditors by writing off their claims or converting them to equity. In addition, a contribution from a resolution financing arrangement, which can only be made after a minimum of 8% of bail-in has taken place, is also a pre-condition for the use of the DRI. While the likelihood of its use has diminished, the DRI remains a potentially useful instrument, within the given mandate of the ESM as a lender of last resort for euro area sovereigns and as an investor of last resort to break the sovereign-bank feedback loop.

The DRI is very different in nature from the other forms of financial assistance that the ESM provides by lending to sovereigns. The ESM undertook a major internal project to be operationally prepared and capable of properly managing the risks if called upon to provide DRI and meet the dual objectives of supporting a systemic bank while minimising the risk of loss to the ESM and taxpayers. The project delivered clear and workable internal guidelines on how to conduct a DRI investment covering due diligence, valuation, structuring and transaction monitoring, funding strategy, systems enhancements, legal and risk frameworks, and an internal governance process. The relevant DRI documentation was established and approved by the ESM Board of Directors.

The ECB's Comprehensive Assessment confirmed the generally sound level of capital of systemic euro area banks after the banks prepared for the exercise by undertaking significant capital raising and other measures. Although unlikely at the present time, DRI may still be required to counter one-off events or systemic disruptions, as an instrument of last resort.



REGIONAL FINANCIAL INSTITUTIONS – ESM IS THE BIGGEST BY FAR

In a world of increasingly integrated capital markets, the global financial crisis and subsequent European financial instability underscored the necessity of setting up credible financial backstops for crisis prevention and resolution. Countries that are under severe financial strain may be shut out of capital markets and need to seek immediate financing assistance, while others with sound domestic policies and fundamentals may also suffer from excessive capital outflows spurred by heightened financial market risk aversion or spillover from other countries. To tackle this problem, the Group of Twenty (G20) industrialised and emerging market economies have promoted an initiative to strengthen a multi-layered Global Financial Safety Net (GFSN), with Regional Financing Arrangements (RFAs) as an important component.

The European experience in dealing with recent crises highlights the importance of mobilising regional financial resources to complement IMF lending. The total resources available at existing RFAs, $1.2 trillion in 2013, almost reached the IMF's $1.4 trillion that same year. The EFSF and ESM stand out with their combined lending capacity totalling €700 billion – the biggest among RFAs – covering 6.2% of Members' total gross domestic product and 950% of Members' aggregate IMF quota shares.

There are eight other major RFAs in the world. Some of them, such as the Arab Monetary Fund or Fondo Latinoamericano de Reservas, were created in the immediate aftermath of past crisis episodes. A few other RFAs have been created or further institutionalised in recent years.

In Europe, several crisis resolution mechanisms with different country coverage and lending capacity precede the creation of the EFSF and ESM. The EU created a balance of payment assistance facility, raising its lending capacity to reach a maximum of €50 billion in 2009. It could provide financial assistance to nine non-euro area countries. An equivalent mechanism was reproduced for the EU in May 2010 under the name of the European Financial Stabilisation Mechanism with a lending capacity of €60 billion to help resolve the euro area crisis. It was activated for Ireland and Portugal for €48.5 billion.

Asia took a significant step towards stronger regional coordination in crisis prevention in 2010.

On 24 March 2010, the existing bilateral swap line agreements – Chiang Mai Initiative – were merged into a single contract called Chiang Mai Initiative Multilateralisation (CMIM). It covers 10 ASEAN countries plus China, Japan, and Korea. CMIM's total size has been increased twice in the recent financial crisis, to $240 billion in 2012 from $78 billion in 2008. A surveillance unit for the CMIM was also created in 2011 to monitor and analyse regional economies.

Armenia, Belarus, Kazakhstan, the Kyrgyz Republic, Russia, and Tajikistan founded an Anti-Crisis Fund of the Eurasian Economic Community in July 2009. Uniquely financed by members' capital contributions, this fund has a total lending capacity of $8.5 billion; Tajikistan and Belarus have both benefited from this regional facility.

Finally, the five biggest emerging market economies signed a treaty establishing the BRICS Contingent Reserve Arrangement in July 2014. The newest RFA, whose shareholders are Brazil, Russia, India, China and South Africa, is endowed with $100 billion in capital. It is composed of multilateral swap lines akin to those of the CMIM.

In addition to the creation or further institutionalisation of RFAs, G20 countries also adopted the *Principles for cooperation between the IMF and RFAs* in 2011. The EFSF and ESM programmes have provided good examples of how an RFA and the IMF can work together. Whenever possible, the IMF is an integral part of European financial assistance programmes. It has co-financed several programmes, conducted programme reviews and country surveillance jointly with European institutions, and has provided technical assistance. RFAs have comparative advantages in sustaining financial stability at the regional level. They have in-depth knowledge of region-specific issues and can mobilise large amounts of financing relatively quickly.

Founded by regional members, RFAs may also enhance democratic support in regional economies. Generally, efficient coordination between the IMF and RFAs generates synergies in terms of resource allocation and surveillance capacity. It also precludes 'programme shopping' and the associated moral hazard by ensuring consistent sets of economic conditions linked to financial assistance.

Figure 27 a. Lending capacity relative to regions' GDP (%)

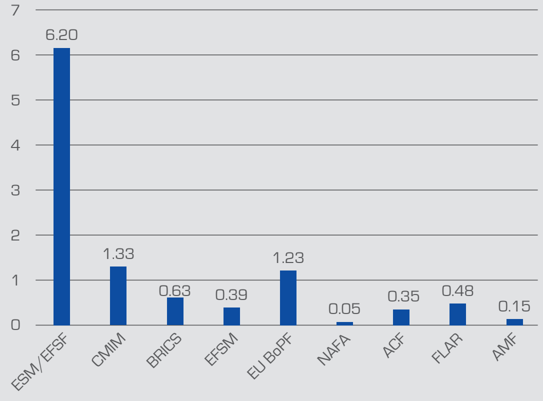
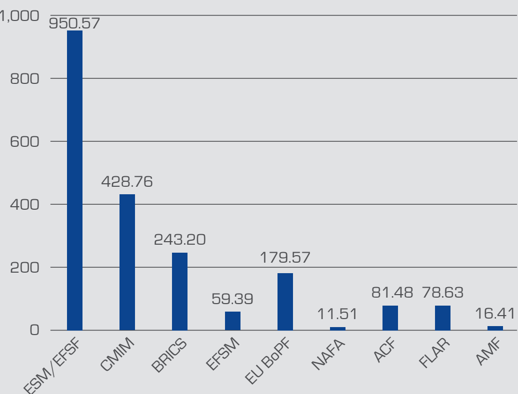


Figure 27 b. Lending capacity relative to regions' IMF quota (%)



Notes: GDP data as of the fourth quarter of 2013 from the World Bank's World Development Indicators.
GDP data are missing for Myanmar, Palestine, Somalia and Syria.
CMIM = Chiang Mai Initiative Multilateralisation; BRICS = BRICS Contingent Reserve Arrangement; EFSM = European Financial Stabilisation Mechanism; EU BoPF = EU Balance of Payments Facility; NAFA = North American Framework Agreement; ACF = Anti-Crisis Fund; FLAR = Fondo Latinoamericano de Reservas; AMF = Arab Monetary Fund.
Sources: RFA official documents; IMF; World Bank; ESM calculations

Governance

ESM SHAREHOLDERS

The ESM shareholders are the 19 euro area Member States. Their subscription to ESM authorised capital is based on the ECB's capital contribution key in force at the time of the signature of the ESM Treaty on 2 February 2012. At equal weighting, this key reflects the ESM Members' respective shares of the EU total population and gross domestic product.

The accession of new Member States is factored into the capital key, slightly reducing the founding ESM Members' contribution keys. Nominal capital subscription and paid-in capital amounts remain unchanged.

In line with Article 42 of the ESM Treaty, ESM Members with a gross domestic product (GDP) per capita of less than 75% of the EU average in the year immediately preceding their ESM accession benefit from a temporary correction mechanism. Both recent ESM joiners Latvia and Lithuania benefit from this temporary correction, which applies for 12 years after the date of euro adoption. During this period, the initial capital subscription of the ESM Member benefiting from the correction will be lower, thus leading temporarily to a lower paid-in capital contribution. Once the temporary correction comes to an end, the ESM Member must deposit the remaining amount.

LATVIA ACCEDES TO ESM TREATY

Latvia joined the euro area on 1 January 2014, following the Council of the European Union's approval in 2013. According to the ESM Treaty, all euro area Member States become ESM Members. As such, following the Board of Governors' 2013 approval, Latvia officially became the 18th ESM Member on 13 March 2014 – making it the first new Member State to join the ESM since its October 2012 inauguration. Latvia qualifies for a temporary correction, and its capital contribution key was therefore set at 0.2757%, resulting in a capital subscription of €1.93 billion, including €221.2 million in paid-in capital. Latvia will make the payments of paid-in capital in five annual instalments of €44.24 million each. Latvia paid the first instalment on 19 March 2014 and the second on 18 March 2015. Once the temporary correction comes to an end in 2026, Latvia must deposit the remaining €102.9 million.

LITHUANIA ACCEDES TO ESM TREATY

Lithuania joined the euro area on 1 January 2015, following formal approval by the Council of the European Union in 2014. In October 2014, the Board of Governors approved Lithuania's application for ESM membership and Lithuania officially became the 19th ESM Member on 3 February 2015.

Based on the temporary correction mechanism, Lithuania's capital contribution key was set at 0.4063% resulting in a capital subscription of €2.86 billion, including €327.2 million in paid-in capital. Lithuania will pay the paid-in capital in five annual instalments of €65.44 million each. Lithuania paid the first instalment on 11 February 2015, and the remaining four instalments will be paid annually through 2019. Once the temporary correction comes to an end in 2027, Lithuania must deposit the remaining €159.4 million.

Table 7. Shares and capital, by ESM Member

As of 18 March 2015.

ESM Members	ESM key (%)	Number of shares	Subscribed capital (€ 000)	Paid-in capital (€ 000)
Belgium	3.4534	243,397	24,339,700	2,781,680
Germany	26.9616	1,900,248	190,024,800	21,717,120
Estonia	0.1847	13,020	1,302,000	148,800
Ireland	1.5814	111,454	11,145,400	1,273,760
Greece	2.7975	197,169	19,716,900	2,253,360
Spain	11.8227	833,259	83,325,900	9,522,960
France	20.2471	1,427,013	142,701,300	16,308,720
Italy	17.7917	1,253,959	125,395,900	14,330,960
Cyprus	0.1949	13,734	1,373,400	156,960
Latvia	0.2746	19,353	1,935,300	88,480
Lithuania	0.4063	28,634	2,863,400	65,440
Luxembourg	0.2487	17,528	1,752,800	200,320
Malta	0.0726	5,117	511,700	58,480
Netherlands	5.6781	400,190	40,019,000	4,573,600
Austria	2.7644	194,838	19,483,800	2,226,720
Portugal	2.4921	175,644	17,564,400	2,007,360
Slovenia	0.4247	29,932	2,993,200	342,080
Slovakia	0.8184	57,680	5,768,000	659,200
Finland	1.7852	125,818	12,581,800	1,437,920
Total	**100**	**7,047,987**	**704,798,700**	**80,153,945.920**

Source: ESM

ESM GOVERNANCE STRUCTURE

BOARD OF GOVERNORS

The Board of Governors is the ESM's highest decision-making body. It comprises government representatives of each ESM Member with responsibility for finance. Representatives of the EC and the ECB may participate in its meetings as observers. The Board of Governors is chaired by the President of the Eurogroup, Jeroen Dijsselbloem.

BOARD OF DIRECTORS

The Board of Directors consists of senior civil service officials from each ESM Member who are highly competent in economic and financial matters. The EC and the ECB may participate in its meetings as observers. The Board of Directors ensures that the ESM is run in accordance with the ESM Treaty and the By-Laws. It takes decisions as provided for in the ESM Treaty or as delegated by the Board of Governors.

BOARD OF AUDITORS

The Board of Auditors is an independent oversight body composed of five members. They are appointed by the Board of Governors upon proposal of the Chairperson of the Board of Governors, the supreme audit institutions of the ESM Members on a rotating basis, and the European Court of Auditors.

COMPENSATION COMMITTEE

The Compensation Committee advises the Board of Directors and the Managing Director on matters of staff compensation and periodically revises the framework and principles of staff compensation, the total annual salary mass and the evolution of the salary band boundaries.

Finance Committee

Approves and takes action on matters related to ESM structural risks as defined in the ESM Risk Policy, mainly re-financing, liquidity and interest rate risks related to its operations.

Banking Committee

Performs technical reviews and provides final internal approval prior to the submission of proposals linked to the direct recapitalisation instrument (DRI) to the Board of Governors, Board of Directors or any other external counterparties.
The Banking Committee only convenes in the context of a DRI operation and therefore did not formally meet during 2014.

Investment Management Committee

Considers matters regarding the implementation of the ESM Guideline on Investment Policy for the ESM Investment Portfolios and the Liquidity Buffer.

chaired by:

Finance Committee	Banking Committee	Investment Management Committee
MANAGING DIRECTOR	MANAGING DIRECTOR	DEPUTY MANAGING DIRECTOR AND CHIEF FINANCIAL OFFICER

MANAGING DIRECTOR

The Managing Director, Klaus Regling, is responsible for conducting the current business of the ESM under the direction of the Board of Directors. The Managing Director chairs the meetings of the Board of Directors and participates in those of the Board of Governors. He is the ESM's chief of staff and legal representative.

MANAGEMENT BOARD

The Management Board assists the Managing Director in conducting the current business of the ESM, preparing the decisions of the Board of Governors and the Board of Directors and seeing to their implementation.

RISK COMMITTEE

The Risk Committee advises the Board of Directors on the ESM's overall current and future risk appetite. It also assists the Board of Directors in reviewing and overseeing the implementation of the ESM risk management framework by the Managing Director.

INTERNAL COMMITTEES

Internal Risk Committee

Considers any matters regarding the evaluation, monitoring and approving of practices linked to the implementation of the ESM Risk Management Framework and risk management within ESM operations.

CHIEF RISK OFFICER

Corporate Projects Committee

Prioritises, approves, and oversees the execution of all ESM corporate projects.

SECRETARY GENERAL

Incident Management Team

Oversees the development and implementation of an effective business continuity capability within the ESM and coordinates the ESM response in the event of incidents that may affect normal ESM operations.

SECRETARY GENERAL

Board of Governors

Annual Meeting 19 June 2014

KEY DECISIONS

The Board of Governors meets at least once a year and whenever the affairs of the ESM so require.

In 2014, the Board of Governors held five meetings and took the following key decisions:

- Approved three updates to the Memorandum of Understanding with Cyprus (1 April 2014, 7 July 2014 and 8 December 2014).
- Approved the ESM 2013 Annual Report (19 June 2014).
- Approved the accession of Lithuania to the ESM (13 October 2014).
- Established the instrument for the Direct Recapitalisation of Institutions (8 December 2014).
- Appointed PricewaterhouseCoopers (PwC) as independent external auditor for a three-year term (8 December 2014).

ANNUAL MEETING OF THE BOARD OF GOVERNORS

On 19 June 2014, the Board of Governors held its second annual meeting at the ESM premises in Luxembourg during which it approved the ESM 2013 Annual Report as drawn up by the ESM Managing Director. In addition, the Chairperson of the Board of Auditors and the external auditor addressed the Governors with regard to the 2013 Financial Statements.

The Managing Director presented the Governors with an overview of key ESM developments and institutional affairs of the past financial year. The annual meeting also allowed the ESM management and staff to have a direct exchange with the ESM Governors. The Governors welcomed the considerable progress the ESM had made in maturing as an institution and acknowledged that the ESM as a permanent institution had proven to be an important pillar in the architecture of the euro area.

SHAREHOLDER ENGAGEMENT

The ESM places great emphasis on shareholder relations and engagement. Since its inception, the ESM has participated in the various political forums where its shareholders are represented to discuss matters of relevance to its mandate, such as the Eurogroup, the Eurogroup Working Group, and the Task Force for Coordinated Action. In 2014, the ESM launched various initiatives to reinforce accountability and enhance shareholder relations. At its debut Shareholders Day, the ESM welcomed representatives from the finance ministries of ESM Members to help deepen their technical understanding of the ESM's operations. The ESM also implemented an extended reporting tool for shareholders via a secure online interface. The development of an online shareholder relations tool, covering Board activity, institutional archives and reporting, was initiated in the second half of 2014.

THE NETHERLANDS
Jeroen Dijsselbloem,
Chairman of the Board of Governors,

Minister of Finance,
appointed on 27 September 2012

BELGIUM
Johan Van Overtveldt,
Minister of Finance,
appointed on 15 December 2014,

- replacing Koen Geens,
  originally appointed on 27 March 2013

GERMANY
Wolfgang Schäuble,
Federal Minister of Finance,
appointed on 27 September 2012

ESTONIA
Sven Sester,
Minister of Finance, appointed on 9 April 2015,

- replacing Maris Lauri,
  originally appointed on 3 November 2014,
- who replaced Jürgen Ligi,
  originally appointed on 27 September 2012

IRELAND
Michael Noonan,
Minister of Finance, appointed on
27 September 2012

GREECE
Yanis Varoufakis,
Minister of Finance, appointed on 27 January 2015,

- replacing Gikas Hardouvelis,
  originally appointed on 10 June 2014,
- who replaced Giannis Stournaras,
  originally appointed on 27 September 2012

SPAIN
Luis de Guindos Jurado,
Minister of Economy and Competitiveness,
appointed 27 September 2012

FRANCE
Michel Sapin,
Minister of Finance and Public Accounts,
appointed on 2 April 2014,

- replacing Pierre Moscovici,
  originally appointed on 27 September 2012

ITALY
Pier Carlo Padoan,
Minister of Economy and Finance,
appointed on 22 February 2014,

- replacing Fabrizio Saccomanni,
  originally appointed on 28 April 2013

CYPRUS
Harris Georgiades,
Minister of Finance, appointed on 3 April 2013

LATVIA
Jānis Reirs,
Minister of Finance, appointed on
5 November 2014,

- replacing Andris Vilks, originally appointed on
  13 March 2014

LITHUANIA
Rimantas Šadžius,
Minister of Finance, appointed on 3 February 2015

LUXEMBOURG
Pierre Gramegna,
Minister of Finance, appointed on 4 December 2013

MALTA
Edward Scicluna,
Minister for Finance, appointed on 13 March 2013

AUSTRIA
Hans Jörg Schelling,
Minister of Finance, appointed on
1 September 2014

- replacing Michael Spindelegger, originally appointed
  on 16 December 2013

PORTUGAL
Maria Luís Albuquerque,
Minister of State and Finance, appointed on
2 July 2013

SLOVENIA
Dušan Mramor,
Minister of Finance,
appointed on 18 September 2014,

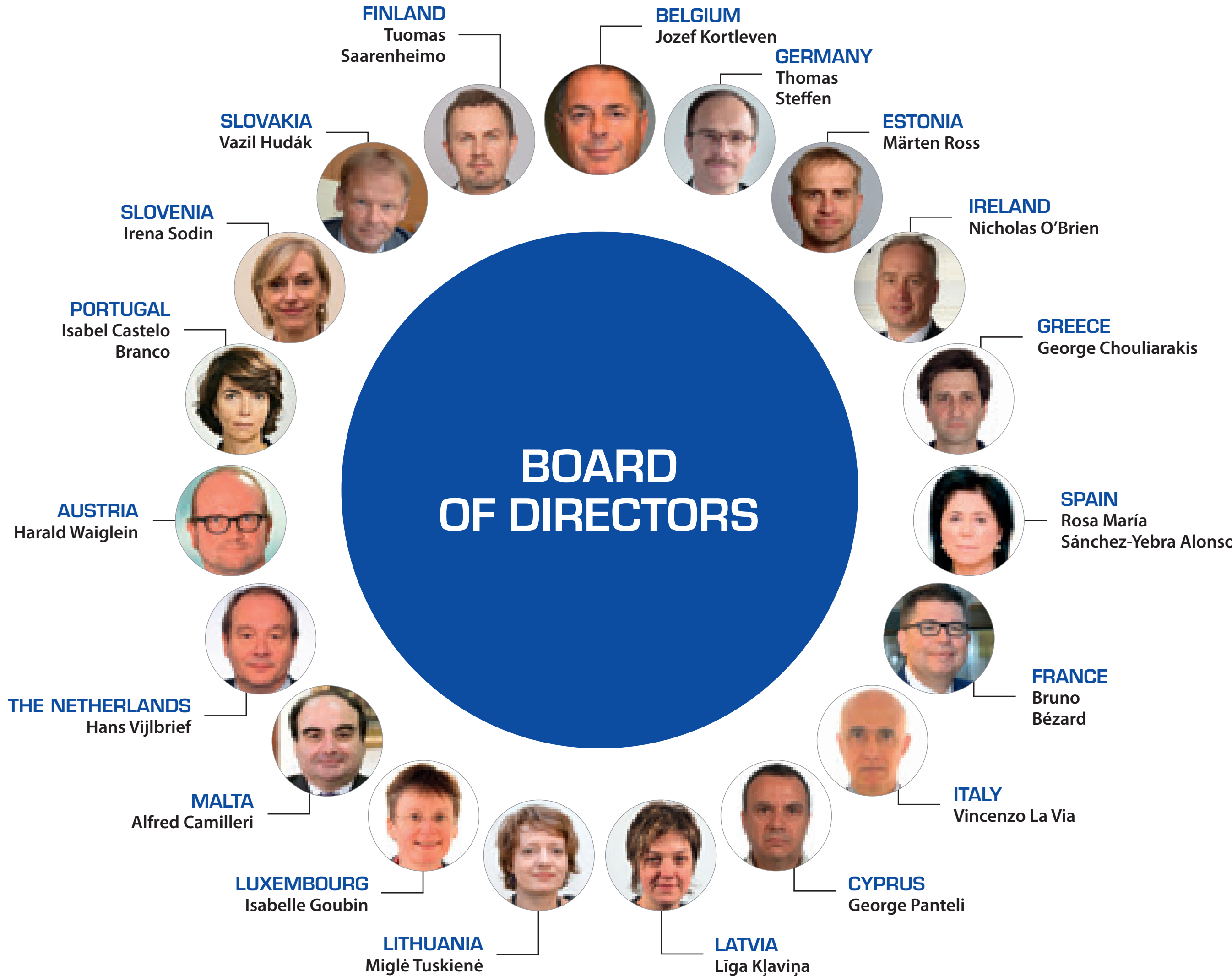
- replacing Uroš Čufer, originally appointed on
  21 March 2013

SLOVAKIA
Peter Kažimír,
Deputy Prime Minister and Minister of Finance,
appointed on 27 September 2012

FINLAND
Antti Rinne,
Minister of Finance, appointed on 6 June 2014,

- replacing Jutta Urpilainen, originally appointed on
  27 September 2012

Board of Directors



KEY DECISIONS

The Board of Directors' meetings are chaired by the Managing Director. In 2014, the Board of Directors held 11 meetings and took the following key decisions:

- Replaced members of the Risk Committee (27 February and 30 September 2014).
- Adopted the ESM Code of Conduct (12 March 2014).
- Approved the Early Warning System Procedure (24 March 2014).
- Appointed the members of the ESM Administrative Tribunal (24 March 2014).
- Approved the disbursement of three tranches of financial assistance to Cyprus (2 April, 7 July and 8 December 2014).
- Appointed new members and chairperson of the Compensation Committee (24 April and 30 September 2014).
- Approved the voluntary partial prepayment of Spain's ESM loan (7 July 2014).
- Approved the administrative budget for the financial year 2014 (27 November 2014).
- Approved the renewal of the ESM diversified funding strategy (27 November 2014).
- Approved implementing documentation in relation to the instrument for direct recapitalisation of institutions (8 December 2014).

BELGIUM
Jozef Kortleven,
Counselor General, Ministry of Finance, appointed on 28 September 2012

GERMANY
Thomas Steffen,
State Secretary, Federal Ministry of Finance, appointed on 24 September 2012

- Member of the Compensation Committee from 9 October 2012, reappointed until 9 October 2017

ESTONIA
Märten Ross,
Deputy Secretary General for Financial Policy and External Relations, Ministry of Finance, appointed on 21 October 2013

IRELAND
Nicholas O'Brien,
Assistant Secretary, International and EU Division, Department of Finance, appointed on 1 July 2014

- Member of the Compensation Committee from 30 September 2014 until 9 October 2016,

replacing James O'Brien, originally appointed on 9 October 2012

- Member of the Compensation Committee from 21 March 2013 until 1 July 2014

GREECE
George Chouliarakis,
Chairman, Council of Economic Advisors, appointed on 4 February 2015,

replacing Anastasios Anastasatos, originally appointed on 13 November 2014,

who replaced Christodoulos Stefanadis, originally appointed on 24 June 2014,

who replaced Paniagiotis Tsakloglou, originally appointed on 27 September 2012

SPAIN
Rosa María Sánchez-Yebra Alonso,
Secretary General for the Treasury and Financial Policy, appointed on 25 September 2014

- Member of the Compensation Committee from 9 October 2014 until 9 October 2017,

replacing Iñigo Fernandez de Mesa Vargas, originally appointed on 8 October 2012

- Member of the Compensation Committee from 9 October 2012 until 25 September 2014

FRANCE
Bruno Bézard,
Director General of the Treasury, Ministry of Finance and Public Accounts, appointed on 2 July 2014,

replacing Ramon Fernandez, originally appointed on 5 October 2012

ITALY
Vincenzo La Via,
Director General of the Treasury, Ministry of Economy and Finance, appointed on 4 October 2012

- Chairman of the Board Risk Committee from 9 October 2012 until 8 October 2015

CYPRUS
George Panteli,
Senior Economic Officer, Ministry of Finance, appointed on 29 April 2013

LATVIA
Līga Kļaviņa,
Deputy State Secretary, Ministry of Finance, appointed on 30 January 2015,

replacing Baiba Bāne, originally appointed on 22 July 2014

who replaced Sanita Bajāre, originally appointed on 13 March 2014

LITHUANIA
Miglė Tuskienė,
Financial Counsellor, Ministry of Finance, appointed on 4 March 2015

LUXEMBOURG
Isabelle Goubin,
Director of the Treasury, Ministry of Finance, appointed on 19 March 2014

- Member of the Compensation Committee from 24 April 2014 to 8 October 2015,

replacing Georges Heinrich, originally appointed 9 October 2012,

- Chairman of the Compensation Committee from 9 October 2012 until 19 March 2014

MALTA
Alfred Camilleri,
Permanent Secretary, Ministry of Finance, appointed on 28 September 2012

- Member of the Compensation Committee from 9 October 2012 until 9 October 2016
- Chairman of the Compensation Committee from 24 April 2014 until 9 October 2016

THE NETHERLANDS
Hans Vijlbrief,
Treasurer-general of the Ministry of Finance, appointed on 5 October 2012

- Member of the Board Risk Committee from 9 October 2012 until 9 October 2014, reappointed until 9 October 2017

AUSTRIA
Harald Waiglein,
Director General for Economic Policy and Financial Markets of the Federal Ministry of Finance, appointed on 8 October 2012

- Member of the Board Risk Committee from 9 October 2012 until 8 October 2016

PORTUGAL
Isabel Castelo Branco,
Secretary of State of the Treasury, appointed on 14 January 2014

- Member of the Board Risk Committee from 27 February 2014 until 8 October 2016,

replacing João Sousa, originally appointed on 27 September 2012

- Member of the Board Risk Committee from 9 October 2012 until 14 January 2014

SLOVENIA
Irena Sodin,
State Secretary, Ministry of Finance, appointed on 24 October 2014,

replacing Mitja Mavko, originally appointed on 17 April 2013

SLOVAKIA
Vazil Hudák,
State Secretary, Ministry of Finance, appointed on 28 September 2012

- Member of the Board Risk Committee from 9 October 2012 until 9 October 2014, reappointed until 9 October 2017

FINLAND
Tuomas Saarenheimo,
Permanent Under-Secretary, Ministry of Finance, appointed on 12 September 2013

Board of Auditors

The members of the Board of Auditors were initially appointed on 8 October 2012 for a non-renewable term of three years, with the exception of Katarína Kaszasová and Ulrich Graf, whose names were drawn by lot to be appointed for a non-renewable term of four years in order to ensure Board continuity. New members to the Board of Auditors will be appointed for a non-renewable term of three years.

NAME	TERMS OF OFFICE
Ulrich Graf	Chairperson as of 8 October 2014 Vice Chairperson from 21 March 2014 until 7 October 2014 Member as of 8 October 2012
Igors Ludboržs	Vice Chairperson as of 8 October 2014 Member as of 19 December 2013
Katarína Kaszasová	Chairperson from 21 March 2014 until 8 October 2014 Vice Chairperson as of 8 October 2012 until 20 March 2014 Member as of 8 October 2012
Marc Gengler	Member as of 8 October 2012
Jules Muis	Member as of 8 October 2012

The Board of Auditors inspects the ESM accounts and verifies that the operational accounts and the balance sheet are in order. Furthermore, it audits the regularity, compliance, performance, and risk management of the ESM in accordance with international auditing standards and monitors the ESM internal and external audit processes and their results.

In 2014, the Board of Auditors held nine meetings and met once with the ESM Board of Directors. The Chairperson of the Board of Auditors met with the Chairperson of the Board of Governors and attended the annual meeting of the Board of Governors. During its meetings, ESM management and senior staff updated the Board of Auditors regularly on ESM activities, the ESM governing bodies and other relevant issues and developments.

The Board of Auditors was also provided with presentations and written opinions by the ESM management as well as external experts on specific topics requested by them. The Board of Auditors met regularly with the internal audit function and monitored and reviewed the work and independence of the external auditors. Between July and November 2014, the Board of Auditors acted as observer to the ESM external audit procurement process for the financial years 2014–2016.

In fulfilling its role, the Board of Auditors also reviewed the ESM Financial Statements as of 31 December 2014 and the working papers of the external auditor. The Board of Auditors carried out an independent audit of the ESM Risk Management in January 2014 and of the ESM Lending Operations in November 2014. In February 2015, it conducted a follow-up review of the ESM Risk Management.

The Board of Auditors prepares an annual report in respect of the ESM financial statements which is contained in the ESM Annual Report in addition to the external auditor's opinion. The Board of Auditors draws up an annual report for the Board of Governors which summarises its audit work and recommendations for the respective year. This report is made accessible to the national parliaments and the supreme audit institutions of the ESM Members, as well as to the European Court of Auditors and the European Parliament.

Maria Luís Albuquerque
Portugal

The ESM has been an important achievement in deepening the EMU and reinforcing the stability of the euro area. It represents what most unites Member States, a sense of common goals and objectives to ensure the euro area and the EU as a whole remain united, strong and fit to provide its citizens with growth and jobs.

INTERNAL CONTROL

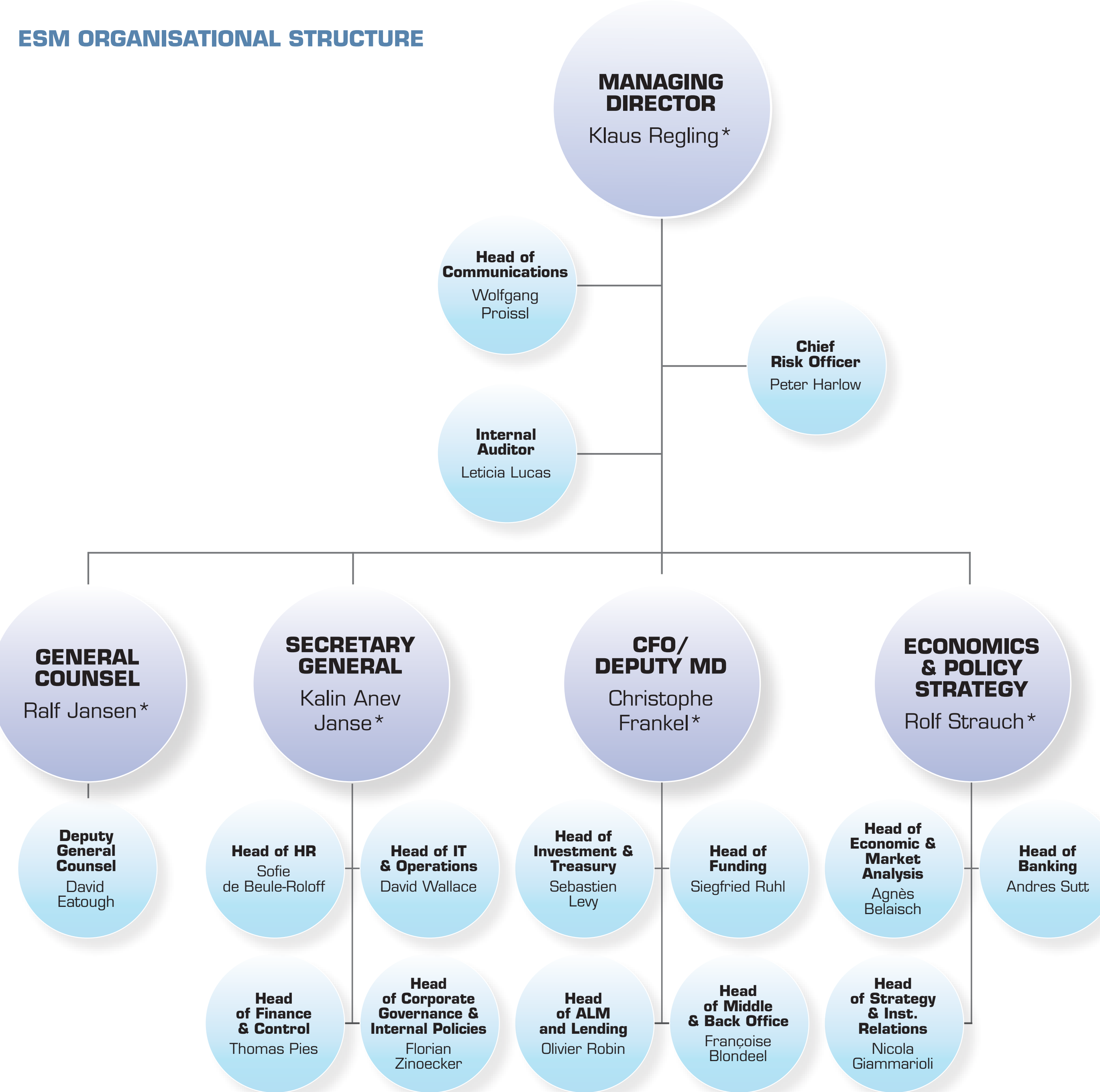
The ESM recognises the importance of effective internal controls, which provide the foundation for the safe and sound operation of the organisation. In October 2013, as part of the maturing of the institution, the Board Risk Committee supported the implementation of the principles of the Basel Committee's Framework for Internal Control Systems in Banking Organisations. Since then the ESM has made significant progress in further developing its internal controls with the objective of completing a comprehensive and effective internal control system by the end of 2015. The ESM internal control framework translates the Basel Committee's principles into relevant entity level, process level, and Information Technology controls consistent with the nature, complexity, and risks inherent in the ESM activities. The internal control framework complements the three lines of defence concept, which the Board of Directors established with the ESM Risk Policy.

In 2014, the ESM continued to strengthen its internal control environment by:

- allocating additional staff to the second and third lines of defence;
- developing key institutional policies, including the Code of Conduct applicable to all members of staff, Directors and alternate Directors; the Whistleblowing Procedure; and the Information Security and Data Protection Policies;
- devoting a project to the systematic review and formalisation of internal controls across all areas of the organisation;
- adding controls and automation in the booking of accounting entries and the preparation of the financial statements;
- implementing a central project management office and the set-up of a Corporate Projects Committee;
- developing a comprehensive business continuity plan and a dedicated disaster recovery site.

Organisation

ESM ORGANISATIONAL STRUCTURE



* Member of the Management Board
Note: As of 31 December 2014.

MANAGEMENT BOARD AND HEADS OF DIVISION

Dušan Mramor
Slovenia

"The European Stability Mechanism was born in 2012, as the child of the most severe crisis to hit Europe since the Second World War. It has established itself as a credible backstop for euro zone member countries in financial difficulties. Without the ESM, many countries would have been forced to leave the euro zone."

RESPONSIBILITIES OF DEPARTMENTS

FINANCE

The Finance department is responsible for raising the funds to enable the ESM to fulfil its mission and to structure, negotiate and implement the Financial Assistance Facilities. It monitors and manages the structural risks, such as those related to interest rates or liquidity, and performs the institution's cash management function. The department ensures that all ESM financial transactions are adequately booked, settled, controlled, and reported. It also plays a front-end role in monitoring risks, including counterparty, settlement, and operational. In addition, the department manages the paid-in capital and implements the ESM Investment Policy.

BANKING

The Banking department monitors and analyses the euro area banking system and SSM-supervised banks and participates in financial sector-related programme work in countries benefitting from ESM financial assistance. The department also participates in technical assistance work on banking-related topics. It was responsible for the design and internal implementation of the direct recapitalisation instrument. In January 2015, the Banking department was merged with the Economics and Policy Strategy department, where it continues to handle the same responsibilities.

ECONOMICS AND POLICY STRATEGY

The Economics and Policy Strategy department develops, assesses, and reviews the ESM's policy strategy, financial architecture, and financial assistance instruments. It analyses the general macroeconomic environment and the functioning of the financial markets, specifically in relation to sovereign debt. In addition, it develops the Early Warning System reports on macroeconomic and credit risks in programme countries, develops and maintains credit risk assessment for the ESM investment strategy, and coordinates the ESM's activity with EU and international institutions.

LEGAL

The Legal department provides expert legal support and legal documentation to the ESM and manages the legal risks arising from the organisation's unique mandate. It works closely with all other departments to preserve the ESM's interests, provide an effective contribution to ESM strategy with respect to the integrity of the business, mitigate legal risks that may result from ESM business activities, and provide legal advice regarding ESM activities and operations. The department also manages corporate legal structures and corporate matters, provides transaction support, and is involved in the review of new products.

Peter Kažimír
Slovakia

The European Stability Mechanism is undeniably one of the key institutional anchors designed to safeguard the stability of the euro zone. Impact and aftermath of the crisis on our economies and public finances would undoubtedly be much worse without having the ESM in place.

SECRETARY GENERAL

The Secretary General's department provides key corporate services to the ESM and to external stakeholders, and maintains relations with other international financial institutions and organisations. The department is organised into four areas. Corporate Governance and Internal Policies manages shareholder relations with ESM Members, provides the secretariat for the meetings of the ESM Board of Directors, Board of Governors, and Board of Auditors, and develops ESM internal policies, the internal control framework, and the business continuity planning. It also provides procurement functions and acts as the ESM central project management office. IT and Operations provides all Information Technology, infrastructure and facilities management services required for ESM operations. Finance and Control develops and maintains the ESM accounting policies, monitors and reports on the ESM financial position, and maintains effective internal controls over the preparation, integrity, and fair presentation of the ESM Financial Statements. Human Resources ensures that the ESM attracts and retains excellent staff and fosters an inspiring work environment.

INTERNAL AUDIT

Internal Audit is an independent and objective assurance function that assists the ESM by bringing a systematic and disciplined approach to evaluating and improving the ESM's risk management, internal control, and governance processes. All activities, operations, and processes of the ESM may be subjected to internal auditing. Internal Audit reports directly to the Managing Director and has its objectives set in the ESM Internal Audit Charter.

COMMUNICATIONS

The Communications department is tasked with explaining to the public, media, and all stakeholders the ESM's mandate and actions. To accomplish its task, the department shapes its messages and provides information through all available communication channels: website, social media, publications, visitor groups, interviews, speeches, press conferences, and other public appearances by the Managing Director and the other members of the Management Board. In coordination with the other euro area institutions and the ESM Members, the department seeks to help shape a common political and economic narrative for the entire currency union.

RISK AND COMPLIANCE

The Risk function acts as the ESM's central independent risk oversight function, developing and maintaining a regular inventory of risks, identifying, assessing, and proposing mitigating alternatives. It also reports risks in a consistent manner to ESM management and

Antti Rinne
Finland

The ESM has quickly grown into a mature institution with its excellent management and highly skilled staff. Its sound investment and risk management policies further contribute to the stability of the euro area, making the ESM a valuable component of the monetary union.

SPOTLIGHT
The Finance Minister's view on the ESM

the Board of Directors, setting the limit framework and escalating any limit breaches, and fostering a risk culture throughout the whole organisation. The Compliance function seeks to assist the Managing Director and staff in carrying out the ESM's mission in a manner that stands up to the closest public scrutiny, by implementing a compliance framework which upholds sound and responsible business practices.

HUMAN RESOURCES

The ESM aims to attract and retain top talent in a competitive European and global employment landscape. In 2014, the ESM recruited 41 staff members and reached a total of 136 staff, secondees, trainees, and interims at year-end from over 30 nationalities and a variety of professional backgrounds. The ESM staff is set to grow to 147 by the end of April 2015. One factor that is becoming increasingly critical in recruiting and retaining staff is diversity awareness.

At the ESM we view diversity as multi-faceted, including aspects such as: gender, nationality, religion, race and ethnicity, disability, and sexual orientation. Diversity and inclusion are a key part of the ESM's core values and are thus closely tied to our organisational goals and everyday activities.

In 2014, the ESM took a number of steps to support diversity and inclusion awareness. Given the complexity of the notion of diversity, the ESM organised efforts to promote it in stages. As a first step, the ESM has, in particular, examined opportunities to:

- improve gender balance and empower women;
- encourage the recruitment of women;
- support dual career couples;
- promote working practices accommodating different needs;
- reduce potential obstacles in managing a diverse workforce.

Still, there is room for more progress in different areas of diversity. In particular, the institution can take further measures to create an inclusive environment that promotes greater gender diversity. In support of the diversity initiatives, ESM has initiated partnerships with other EU institutions, the Ministry of Finance in Luxembourg, and local organisations.

The ESM has also organised an internal working group on diversity to advance diversity initiatives and create a platform to exchange information on diversity issues relevant to staff. It is composed of the Secretary General, the Head of Human Resources, the Head of Middle and Back Office, the Head of Economics and Market Analysis, the Senior Internal Auditor and the chairperson of the staff representation committee.

ESM ESTABLISHES ADMINISTRATIVE TRIBUNAL TO DECIDE ON STAFF EMPLOYMENT MATTERS

The Board of Directors established the Administrative Tribunal of the ESM (ESMAT) and adopted its Statute on 29 October 2013, ensuring that ESM staff members can effectively enjoy their human right of access to justice regarding their employment conditions. The independent body hears and passes judgement on staff employment matters within its competence as defined by the Statute.

The ESM needed to establish its own Administrative Tribunal to guarantee staff members' access to justice, because the ESM is a separate legal entity under public international law and its employees cannot currently apply to the Court of Justice of the European Union. The design of the ESMAT complies with the principle of good administration and cost effectiveness, as ESMAT-related costs will be proportionate to the number of cases it handles.

The ESMAT is composed of five members, including a President and a Vice-President. The members are appointed for a renewable term of office of five years, although at the inception of the ESMAT, two of the five members were appointed for an initial term of four years.

On 24 March 2014, the Board of Directors took note of the appointment as members of the ESMAT, of: Julian Currall, for a five-year term; Celia Goldman, for a five-year term; Virginia Melgar, for a four-year term; Haris Tagaras, for a four-year term; and Gerhard Ullrich, for a five-year term. The ESMAT inaugural meeting took place on 10 March 2014. During the meeting, Ms Melgar was elected President and Mr Tagaras, Vice-President.

On 4 December 2014, the ESMAT established, pursuant to Article 5(1) of the Statute, its Rules of Procedure. The ESM also entered into a Memorandum of Understanding with the European Free Trade Association (EFTA) Court in December 2014. Under the agreement, the EFTA Court renders registry services to the ESMAT. On 2 February 2015, a hypothetical test case was filed to test that the procedures were functioning appropriately.

ESM APPOINTS FIRST STAFF REPRESENTATIVES

The ESM appointed its first Staff Representatives in September 2014. Out of eight candidates, three staff members were elected for a two-year term by secret ballot open to all members of staff. Voter turnout was 81%.

The ESM Staff Rules mandate the Staff Representatives to represent the general interests of staff within the ESM. For this purpose they meet regularly with the Managing Director and Secretary General and collaborate on a working level with the Human Resources division. They also consult with staff on a collective and individual basis, communicate relevant developments and management initiatives to staff, and promote staff's awareness and engagement on matters of common interest. Since their election, the Staff Representatives have developed relationships with representative bodies from peer institutions to discuss best practice and inform their work, and are participating members of the pan-institutional College of the Presidents of Staff Committees.

As the ESM continues to mature, the goal of the Staff Representatives is to help meet the ESM's institutional objectives in ways that maintain high staff engagement and support the ESM's unique culture, ultimately strengthening the ESM's ability to fulfil its mandate.

04.

FINANCIAL REPORT

2014 RESULTS

The ESM is the permanent crisis resolution mechanism for the euro area. Its purpose is to provide stability support through a number of financial assistance instruments to ESM Member States which are experiencing, or are threatened by, severe financial problems. The ESM is thus not profit driven and does not provide incentives for speculative exposures of its investment portfolios. The ESM does not aim to reach any budgeted target for its financial result.

The operating income of the ESM is mainly driven by the interest margin on its lending activity and the return of investment on the paid-in capital. The ESM Pricing Policy defines the distinct elements of the total cost of a loan.

Balance Sheet

At year-end, the total balance sheet of the ESM was €752.6 billion, a decrease of €7.8 billion over the previous year, mainly due to the expiry of the Transitional Investment Portfolio (TIP) at the end of 2014.

Loans and advances to euro area Member States decreased by €0.5 billion, following the early repayments from Spain (€-1.6 billion) and new disbursements to Cyprus (€1.1 billion). At year-end, loans amounted to €45.4 billion.

To provide financial assistance to ESM Member States, the ESM relies on its funding activity. In 2014, the total liability in respect of debts evidenced by certificates decreased by 18% to €49.2 billion. The decrease is mainly linked to the expiration of the TIP. The TIP addressed the transitional aspects related to the emergence of the ESM as a new issuer in the financial markets together with the continued rollover activity of the EFSF. Part of the proceeds of short-term ESM-issued funding instruments was invested in short-term EFSF-issued instruments. As of 31 December 2013, the TIP had a value of €9.1 billion.

On 30 April 2014, the 17 euro area Member States which established the ESM completed their scheduled payments of paid-in capital, with the transfer of the fifth and final tranche of €15.7 billion. The ESM has thus achieved its target level of paid-in capital of €80 billion. In addition, Latvia became the ESM's 18th member on 13 March 2014 and made a first instalment for the payment of paid-in shares in the amount of €44.2 million. At year end, the paid-in capital was invested in ESM assets in the form of cash and equivalents, deposits with central banks and debt securities including fixed-income securities.

Unrealised gains or losses resulting from the valuation of the securities portfolio are recognised in the fair value reserve within the equity position of the ESM. As of 31 December 2014, the fair value reserve was €512.9 million compared to €-115.7 million at the end of 2013. Due to the ESM's conservative investment strategy the fair value variation remains very limited and the risk of a loss at maturity or at the time of sale of an investment is generally low.

Profit and Loss account

For the financial year 2014, which was the second full year of operation, the ESM recorded a positive net result of €443.9 million. Compared to 2013, income rose by €190 million.

The ESM recorded interest income of €710.1 million for 2014. In parallel the interest charges in relation to the funding activities amounted to €348.7 million.

In addition to interest income on loans, the investments made from the paid-in capital contributed significantly to ESM results. In 2014, the ESM recognised interest income of €197.9 million on the paid-in capital investments, compared with €81.6 million in 2013. In addition, the realised income from sales of debt securities in the paid-in capital portfolio was €102.9 million, up from €26.1 million in 2013.

The operating costs, which include general administrative expenses and depreciation of fixed assets, increased by €10.3 million, mainly due to an increased number of staff. As the ESM provides administrative services to the EFSF, €21.3 million of the operating costs were charged to the EFSF which are recognised as other operating income. The ESM continues to focus on budgetary discipline and effective cost control.

OUTLOOK FOR 2015

The ESM expects its net realised result to remain relatively stable. The ESM will continue to invest the paid-in capital in line with the established investment policy. Nevertheless, a sustained low interest rate environment might pose challenges in managing the portfolio. To support its financial assistance programmes in 2015, the ESM has a funding target of €12.5 billion. This reflects the early repayment from Spain in the first quarter of 2015.

Financial Statements

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BALANCE SHEET

As at 31 December 2014
(in €'000)

	Notes	31.12.2014	31.12.2013
ASSETS			
Cash in hand, balances with central banks and post office banks	5	**4,388,003**	**4,968,640**
Loans and advances to credit institutions	6		
(a) other loans and advances		18,656,514	22,976,514
		18,656,514	**22,976,514**
Loans and advances to euro area Member States	7	**45,421,460**	**45,933,000**
Debt securities including fixed-income securities	8		
(a) issued by public bodies		55,518,169	46,762,403
(b) issued by other borrowers		6,132,255	3,599,372
		61,650,424	**50,361,775**
Intangible assets	9	**86**	**128**
Tangible assets	10	**3,447**	**2,944**
Subscribed capital unpaid	2.13/15	**621,714,100**	**620,000,000**
Subscribed capital called but not paid	2.13/15	**176,960**	**15,712,416**
Prepayments and accrued income	11	**595,061**	**460,654**
Total assets		**752,606,055**	**760,416,071**
LIABILITIES			
Debts evidenced by certificates	12		
(a) debt securities in issue		49,163,608	60,026,441
		49,163,608	**60,026,441**
Other liabilities	13	**23,591**	**22,831**
Accruals and deferred income	14	**273,367**	**229,112**
Total liabilities		**49,460,566**	**60,278,384**
SHAREHOLDERS' EQUITY			
Subscribed capital	2.13/15	**701,935,300**	**700,000,000**
Fair value reserve	8	**512,863**	**(115,716)**
Reserve fund	2.6.1/16	**253,403**	**-**
Profit/loss brought forward		**-**	**(498)**
Profit for the financial year		**443,923**	**253,901**
Total shareholders' equity		**703,145,489**	**700,137,687**
Total equity and liabilities		**752,606,055**	**760,416,071**

OFF-BALANCE SHEET

As at 31 December 2014
(in €'000)

	Notes	31.12.2014	31.12.2013
OFF-BALANCE SHEET			
Commitments	23		
(a) undisbursed loans to euro area Member States		3,268,000	4,386,000
		3,268,000	**4,386,000**

PROFIT AND LOSS ACCOUNT

For the financial year ending 31 December 2014
(in €'000)

	Notes	2014	2013
Interest receivable and similar income			
(a) on cash and cash equivalents		1	-
(b) on loans and advances to credit institutions		23,002	13,245
(c) on loans and advances to euro area Member States	17	499,608	268,979
(d) on debt securities including fixed-income securities		187,474	70,600
		710,085	**352,824**
Interest payable and similar charges			
(a) on debts issued		(348,662)	(110,680)
		(348,662)	**(110,680)**
Commissions receivable		-	**105**
Commissions payable		**(10)**	**(109)**
Other operating income	18	**21,250**	**17,010**
Net profit on financial operations		**102,931**	**26,093**
General administrative expenses			
(a) staff costs	19	(19,148)	(13,965)
- wages and salaries		(13,501)	(10,292)
- social security		(5,647)	(3,673)
of which relating to pension		*(4,969)*	*(3,196)*
(b) other administrative expenses	20	(21,761)	(16,876)
		(40,909)	**(30,841)**
Value adjustments in respect of intangible and tangible assets		**(762)**	**(501)**
Profit for the financial year		**443,923**	**253,901**

STATEMENT OF CHANGES IN EQUITY

For the financial year ending 31 December 2014
(in €'000)

	Subscribed capital	Fair value reserve	Reserve fund	Profit/loss brought forward	Profit/loss for the financial year	Total
At 1 January 2013	**700,000,000**	**19,548**	-	-	**(498)**	**700,019,050**
Allocation of the result of 2012	-	-	-	(498)	498	-
Profit for the financial year	-	-	-	-	253,901	**253,901**
Fair value reserve	-	(135,264)	-	-	-	**(135,264)**
At 31 December 2013	**700,000,000**	**(115,716)**	-	**(498)**	**253,901**	**700,137,687**

	Subscribed capital	Fair value reserve	Reserve fund	Profit/loss brought forward	Profit for the financial year	Total
At 1 January 2014	**700,000,000**	**(115,716)**	-	**(498)**	**253,901**	**700,137,687**
Subscription of capital	1,935,300	-	-	-	-	**1,935,300**
Allocation of the result of 2013	-	-	-	253,901	(253,901)	-
Allocation of profit brought forward to the reserve fund	-	-	253,403	(253,403)	-	-
Profit for the financial year	-	-	-	-	443,923	**443,923**
Fair value reserve	-	628,579	-	-	-	**628,579**
At 31 December 2014	**701,935,300**	**512,863**	**253,403**	-	**443,923**	**703,145,489**

STATEMENT OF CASH FLOWS

For the financial year ending 31 December 2014
(in €'000)

	2014	2013
Cash flows from operating activities:		
Profit for the financial year	443,923	253,901
Adjustments for:		
Value adjustments in respect of tangible and intangible assets	762	501
Changes in:		
Tangible and intangible assets	(1,223)	(422)
Accrued interest and interest received	(1,217,211)	(702,405)
Prepayments	(54,115)	(18,596)
Accruals and deferred income and interest paid	301,433	79,744
Other liabilities	760	3,964
Interest received	1,136,919	378,080
Up-front service fee received	5,500	32,325
Interest paid	(262,678)	(70,985)
Net cash provided by operating activities	**354,070**	**(43,893)**
Cash flows from investing activities		
Change in debt securities including fixed-income securities	(10,660,070)	(41,701,005)
Change in loans and advances to credit institutions	4,320,000	(6,475,000)
Loans disbursed during the year	511,540	(6,465,000)
Net cash used in investing activities	**(5,828,530)**	**(54,641,005)**
Cash flows from financing activities		
Payment of capital	15,756,656	31,424,832
Changes in debt securities in issue	(10,862,833)	20,552,891
Net cash provided by financing activities	**4,893,823**	**51,977,723**
Net decrease in cash and cash equivalents	(580,637)	(2,707,175)
Cash and cash equivalents at the beginning of the financial year	4,968,640	7,675,815
Cash and cash equivalents at the end of the financial year	**4,388,003**	**4,968,640**

The accompanying Notes form an integral part of these financial statements.

Notes to the financial statements

1. GENERAL INFORMATION

The **European Stability Mechanism** ("ESM") was inaugurated on 8 October 2012 and established as an international financial institution with its registered office at 6a, Circuit de la Foire Internationale, L-1347 Luxembourg, Grand Duchy of Luxembourg.

The finance ministers of the then 17 euro area countries signed the Treaty establishing the European Stability Mechanism (ESM Treaty) on 11 July 2011. A modified version, incorporating amendments aimed at improving the ESM's effectiveness, was signed in Brussels on 2 February 2012. The ESM Treaty entered into force on 27 September 2012 and the ESM was inaugurated on 8 October 2012 following ratification by the then 17 euro area Member States.

Latvia joined the euro area on 1 January 2014. The Latvian parliament ratified the ESM Treaty on 30 January 2014, and Latvia officially became the ESM's 18th Member on 13 March 2014. The ESM's Treaty was amended.

The present financial statements cover the period from 1 January 2014 to 31 December 2014, while comparative figures cover the period from 1 January 2013 to 31 December 2013.

On a proposal from the Managing Director, the Board of Directors adopted the financial statements on 25 March 2015 and authorised their submission to the Board of Governors for approval at their 18 June 2015 meeting.

1.1. General overview of the financial assistance programmes

The ESM is authorised to make use of the following lending instruments for the benefit of its Members, subject to appropriate conditionality:

- grant financial assistance in the form of loans to an ESM Member (ESM Shareholder) in the framework of a macroeconomic adjustment programme;

- purchase of bonds or other debt securities in the primary debt market and arrange operations on the secondary debt market in relation to the bonds of an ESM Member;

- grant precautionary financial assistance to ESM Members in the form of credit lines;

- provide financial assistance for the recapitalisation of financial institutions through loans to the of ESM Members' governments.

The ESM can also directly recapitalise systemic and viable euro area credit institutions under specific circumstances and as a last resort measure, following the 8 December 2014 ratification of a new instrument, the Direct Recapitalisation of Institutions.

1.2. Overview of the pricing structure of the financial assistance programmes

The total cost of financial assistance to a beneficiary Member State is an aggregate of several distinct elements that are established in the ESM Pricing Policy:

- Base rate – the cost of funding incurred by the ESM, derived by a daily computation of the actual interest accrued on all bonds, bills and other funding instruments issued by the ESM.

- Commitment fee – the negative cost of carry and issuance costs, charged for the period from raising funds by the ESM until disbursement to the beneficiary Member State or for the period from the refinancing of the relevant

funding instrument until its maturity. The commitment fee will be applied ex-post on the basis of the negative carry actually incurred.

- Service fee – the source of general revenues and resources to cover the ESM's operational costs. The service fee has two components:
  - up-front service fee (50 bps) generally deducted from the drawn amount,
  - annual service fee (0.5 bp) paid on the interest payment date.
- Margin – paid on the interest payment date. The margin charged differs across financial support instruments.
  - For loans granted, the margin is 10 bps;
  - For primary market support facility, the margin is 10 bps;
  - For secondary market support facility, the margin is 5 bps;
  - For precautionary financial assistance granted, the margin is 35 bps;
  - For financial assistance provided to an ESM Member for the recapitalisation of its financial institutions, the margin is 30 bps.

In addition, the ESM Pricing Policy includes specific elements tied to financial assistance for the Direct Recapitalisation of Institutions.

Penalty interest may be applied to overdue amounts, which corresponds to a charge of 200 bps over the higher of either the Euribor rate applicable to the relevant period selected by the ESM or the interest rate which would have been payable.

1.3. The ESM's financial assistance to Spain

The Eurogroup, which comprises the finance ministers of the euro area countries, reached political agreement on 20 July 2012 that financial assistance should be granted to Spain for the recapitalisation of its banking sector, following an official request from the Spanish government. The assistance was designed to cover the estimated capital requirements along with an additional safety margin, amounting to €100 billion. The loans were provided to Spain's bank recapitalisation fund, Fondo de Restructuración Ordenado Bancaria (FROB), and then channelled to the relevant financial institutions. The assistance was initially committed under a European Financial Stability Facility ("EFSF") programme. On 28 November 2012, the ESM Board of Governors decided the ESM would assume this commitment, in line with Article 40(1) and (2) of the ESM Treaty.

This was the ESM's first financial assistance programme. It was also the first use of the instrument for recapitalising banks through loans granted to a government. There were no contributions from other lenders.

On 3 December 2012, the Spanish government formally requested the disbursement of €39.5 billion of funds. On 5 December 2012, the ESM launched and priced notes, which were transferred to FROB on 11 December 2012. FROB used these notes for the recapitalisation of €37.0 billion in the following banks: BFABankia, Catalunya-Caixa, NCG Banco and Banco de Valencia. FROB also provided €2.5 billion to Sareb, the asset management company, for assets arising from bank restructuring.

On 28 January 2013, the Spanish government formally requested a second disbursement of €1.8 billion for the recapitalisation of Banco Mare Nostrum, Banco Ceiss, Caja 3 and Liberbank. The funds were transferred to FROB in the form of ESM notes on 5 February 2013.

The ESM financial assistance programme expired on 31 December 2013. In total, the ESM disbursed €41.3 billion to Spain to recapitalise the banking sector. The remaining undisbursed amount of the facility was cancelled.

On 7 July 2014 the ESM Board of Directors approved Spain's voluntary request to make an early repayment of €1.3 billion of its loan. This was the first time a euro area country that benefited from a financial assistance programme requested to make a repayment ahead of schedule. The repayment took place on 8 July 2014 and

was accompanied by a scheduled repayment of unused funds of €0.3 billion on 23 July 2014. Both repayments were made in cash.

1.4. The ESM's financial assistance to Cyprus

The Cypriot Government requested stability support on 25 June 2012. In response, the Eurogroup agreed the key elements of a macroeconomic adjustment programme on 25 March 2013.

The agreement on the macroeconomic adjustment programme led euro area members to decide on a financial assistance package of up to €10 billion. On 24 April 2013, the ESM Board of Governors decided to grant stability support to Cyprus. On 8 May 2013 the ESM Board of Directors approved the Financial Assistance Facility Agreement (FFA). The ESM provides up to €8.968 billion, and the International Monetary Fund (IMF) contributed around €1 billion.

According to the terms of the FFA, the first tranche of financial assistance was provided to Cyprus in two separate disbursements: the first €2.0 billion were disbursed on 13 May 2013, and the second of €1.0 billion on 26 June 2013. The second tranche of assistance, €1.5 billion of ESM floating rate notes, was disbursed on 27 September 2013. The Cypriot government used the notes for the recapitalisation of the cooperative banking sector. The third tranche of assistance, of €0.1 billion, was disbursed on 19 December 2013. During 2014, €1.1 billion in disbursements was made.

The financial assistance facility is designed to cover Cyprus's financing needs after including proceeds from burden-sharing measures that the Cypriot government has adopted. These needs include budgetary financing, the redemption of medium and long-term debt, and the recapitalisation of financial institutions. They exclude the country's two largest banks, Bank of Cyprus and Cyprus Popular Bank, which the Cypriot government subjected to restructuring and resolution measures.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The principal accounting policies applied in the preparation of these financial statements are set out below.

2.1. Basis of presentation

The accompanying financial statements are prepared and presented in accordance with the Directive 86/635/EEC of the Council of the European Communities of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions, as amended by Directive 2001/65/EC of 27 September 2001, by Directive 2003/51/EC of 18 June 2003 and by Directive 2006/46/EC of 14 June 2006 (the 'Directives'). Their specific application by the ESM is described in the subsequent notes. Directive 2006/46/EC has been amended by Directive 2013/34/EU. The ESM applies the same transitional period as that applicable to the Member States for transposition by 2016.

The ESM prepares an Activity Report ('description of policies and activities') that is presented separately from the financial statements.

The preparation of financial statements in conformity with the Directives requires the use of certain critical accounting estimates. It also requires Management[8] to exercise its judgement in applying the ESM's accounting policies. Areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the financial statements are disclosed in Note 2.3.

2.2. Basis of measurement

The accompanying financial statements are prepared on a historical cost basis, except for the loans and advances to euro area Member States and the debts evidenced by certificates which are measured at amortised cost, and

8 As per Article 7 (5) of the ESM Treaty the Managing Director shall conduct, under the direction of the Board of Directors, the current business of the ESM; as per Article 21 (1) of the ESM By-Laws the Board of Directors shall keep the accounts of the ESM and draw up its annual accounts.

the paid-in capital and reserve fund investments which are measured at fair value with gains and losses recognised in the fair value reserve.

2.3. Use of estimates

In preparing the financial statements, Management is required to make estimates and assumptions that affect reported income, expenses, assets, liabilities and the disclosure of contingent assets and liabilities. The use of available information and application of judgement are inherent in the formation of estimates. Actual results in the future could differ from such estimates and the resulting differences may be material to the financial statements. Any revision to accounting estimates is recognised prospectively in current and future periods.

The ESM is entitled to charge 50 bps of up-front service and 0.5 bps annual service fees to cover the ESM's operational cost, as Note 1.2 describes. The ESM recognises the up-front service fees over a seven year period, to reflect the expected occurrences of the expenses that it aims to cover.

ESM reviews its loans and advances to euro area Member States at each reporting date to assess whether a value adjustment should be recorded. The ESM is a permanent crisis resolution mechanism that aims at supporting beneficiary Member States' return to public financial stability. In particular, judgement by management and the ESM governing bodies is required in the estimation of the level of value adjustment, by determining the amount and timing of future cash flows. No value adjustment was required as at 31 December 2014 and 2013, and thus none has been recognised.

2.4. Foreign currency translation

The ESM uses the euro (€) as the unit of measure for the capital accounts of Member States and for presenting its financial statements.

Foreign currency transactions are recorded at the rates of exchange prevailing on the date of the transaction. Exchange differences, if any, arising out of transactions settled during the year are recognised in the profit-and-loss account as net profit or loss on financial operations.

Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are translated at the closing exchange rates on that date.

Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rates at the dates of the initial transactions. Non-monetary items measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value was determined.

The exchange differences, if any, are recognised in the profit-and-loss account and related assets and liabilities are revalued on the balance sheet.

2.5. Cash in hand, balances with central banks and post office banks

Cash in hand, balances with central banks and post office banks include cash in hand, demand deposits and other short-term highly liquid investments with original maturities of three months or less. Bank overdrafts, if any, are shown within borrowings in current liabilities on the balance sheet.

2.6. Debt securities including fixed-income securities

The ESM has established the following portfolio categories to clarify the management of its financial assets:

2.6.1. Paid-in capital and reserve fund investments

The ESM's capital provisions are laid down in Chapter 3 of the ESM Treaty. The initial aggregate nominal value of paid-in shares is €80 billion. The net income generated by the ESM operations and the proceeds of the financial sanctions received from the ESM Members under the multilateral surveillance procedure, the excessive deficit

procedure and the macro-economic imbalances procedure established under the Treaty on the Functioning of the European Union (TFEU) are put aside in a reserve fund, in accordance with Chapter 5 of the ESM Treaty.

The proceeds of the paid-in capital and reserve fund are invested in accordance with the Investment Policy approved by the Board of Directors. The main objective of such investments is to ensure that the maximum lending volume is always readily available, and to absorb potential losses.

The paid-in capital and reserve fund investments are segregated into separate portfolios (investment tranches). The characteristics and relative size of each tranche are described below:

Short-term tranche

The tranche with the highest requirements for the liquidity of investments is the short-term tranche. 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. This tranche is invested in liquid investment instruments with a capital preservation objective at a one-year horizon, with a high level of confidence.

Medium/Long-term tranche

The medium/long-term tranche is designed to ensure the ESM's financial strength. This tranche is managed to enhance the return of the investment portfolios and is 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 monetised.

The paid-in capital and reserve fund investments are initially recognised at fair value including any transaction costs, and measured subsequently at fair value with gains and losses recognised in the fair value reserve, except for impairment losses and foreign exchange gains and losses, until the financial asset is derecognised. Unrealised gains or losses are accumulated in the fair value reserve until such investment is sold, collected or otherwise disposed of, or until such investment is determined to be impaired.

If such financial asset is determined to be impaired, the cumulative gain or loss previously recognised in the fair value reserve is recognised in the profit and loss account. Interest, however, is recognised on a straight-line basis.

2.6.2. Liquidity buffer investments

The ESM's borrowing strategy must meet several objectives and principles to comply with the purpose established in Article 3 of the ESM Treaty. The market environment where the ESM operates is volatile. The general borrowing strategy must therefore allow for a rapid reaction to unexpected market developments, including the build-up of liquidity buffers during periods of systemic risk. This is to ensure market access, even in difficult market environments with a high degree of uncertainty.

The liquidity buffer proceeds are invested in accordance with the investment guidelines for the short-term tranche of the paid-in capital and reserve funds' investments described in Note 2.6.1.

2.6.3. Fee investments

In 2014 the ESM invested the service fees and the margin collected from ESM operations into deposits and short term highly rated debt securities. The fee investment portfolio is invested following the same investment guidelines as for the short-term tranche of the paid-in capital and reserve funds' investments described in Note 2.6.1.

2.6.4. Transitional Investment Portfolio

The transitional investment portfolio, which comprised short-term notes issued by the EFSF, was temporary and expired in November 2014. The portfolio aimed at providing intermediate short-term financing to the EFSF, because the EFSF bill programme was substituted by the ESM bill programme. This portfolio allowed the EFSF to roll short-term funding from the former EFSF bill programme into long-term funding.

The securities in this portfolio were initially recognised at fair value, including any transaction costs, and were subsequently measured at fair value. Gains and losses were recognised in the fair value reserve, except for impairment losses and foreign exchange gains and losses, until the financial asset was derecognised. Unrealised gains or losses were accumulated in the fair value reserve until these investments were derecognised.

2.6.5. Determination of fair value

For financial instruments traded in active markets, the determination of fair values for financial assets and financial liabilities is based on quoted market prices or dealer price quotations.

A financial instrument is considered to be trading in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis.

Where the fair values of financial instruments recorded on the balance sheet cannot be derived from active markets, they are determined using valuation techniques that include the use of mathematical models. The chosen valuation techniques incorporate factors that market participants would take into account in pricing a transaction and are based whenever possible on observable market data. If such data is not available, a degree of judgement is required in establishing fair values.

2.7. Loans and advances to credit institutions and to euro area Member States

Loans and advances are non-derivative financial assets with fixed or determinable payments that are not traded in an active market. Loans and advances are initially recognised at their net disbursement amounts, and subsequently measured at amortised cost.

Transaction costs and premiums/discounts are amortised in the profit-and-loss account through interest receivable and similar income. Interest income on loans and advances to credit institutions and to euro area Member States are also included in interest receivable and similar income in the profit-and-loss account.

Specific value adjustments present the risks of non-recovery for all or part of their amounts. Value adjustments are accounted for in the profit-and-loss account as value adjustments in respect of loans and advances and are deducted from the appropriate asset items on the balance sheet.

2.8. Intangible assets

Intangible assets are recorded on the balance sheet at their acquisition cost, less accumulated amortisation. Amortisation is calculated on a straight-line basis over the estimated life of each item purchased. Intangible assets comprise computer software that are amortised within three years.

2.9. Tangible assets

Tangible assets are recorded on the balance sheet at their acquisition cost, less accumulated depreciation.

Depreciation is calculated on a straight-line basis over the estimated life of each item purchased, as set out below:

- permanent equipment, fixtures and fittings: nine years or until the end of building rent period;
- furniture and office equipment: five years;
- IT equipment: three years.

If works performed on leased properties are capitalised (as fixture and fittings) then the estimated life of those assets should not exceed the duration of the lease agreement.

2.10. Prepayments and accrued income

Prepayments and accrued income are related to invoices received and paid in advance as the underlying expense is not exclusively related to the reporting period together with any income relating to the financial year in question, which will only be received in the course of a subsequent financial year.

2.11. Debts evidenced by certificates

Debts evidenced by certificates are presented at their amortised cost. Transaction costs and premiums/discounts are amortised in the profit-and-loss account through interest payable and similar charges. Interest expenses on debt instruments are also included in interest payable and similar charges in the profit-and-loss account.

2.12. Provisions

Provisions are intended to cover liabilities the nature of which is clearly defined and which at the date of the balance sheet are either likely to be incurred, or certain to be incurred but uncertain as to the amount or as to the date on which they will arise.

Where there are similar obligations, the likelihood that an outflow will be required in settlement is determined by considering the class of obligations as a whole.

2.13. Subscribed capital

As at 31 December 2014 the ESM's shareholders were the 18 euro area Member States. In accordance with Article 8 of the ESM Treaty, the initial authorised capital is €701.9 billion, which is divided into 7,019,353 shares, with a nominal value of €100,000 each. The initial authorised capital was subscribed by the shareholders according to the initial contribution key provided in Article 11 and calculated in Annex I of the ESM Treaty. The authorised capital was divided into paid-in shares and callable shares, where the initial total aggregate nominal value of paid-in shares was €80.2 billion.

In accordance with Article 4 of Directive 86/635/EEC as amended, the initial authorised capital stock of €701.9 billion is recognised in equity as subscribed capital. The callable shares are presented as subscribed capital unpaid on the asset side of the balance sheet. Called capital not yet paid by the shareholders is recognised on the asset side of the balance sheet as subscribed capital called but not paid.

2.14. Accruals and deferred income

Accruals and deferred income are related to income received before the balance sheet date but not exclusively related to the reporting period, together with any charges which, though relating to the financial year in question, will only be paid in a subsequent financial year.

2.15. Interest receivable and payable

Interest income and expenses for all interest-bearing financial instruments are recognised within interest receivable and interest payable in the profit-and-loss account on an accrual basis.

Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

On the balance sheet, accrued interest is included in 'Prepayments and accrued income' under assets and in 'Accruals and deferred income' under liabilities.

2.16. Employee benefits

(a) Pension obligation

For a transition period from 1 January 2013 to 30 April 2013, the ESM was affiliated with the Luxembourg national social security system on a voluntary basis. As a complementary insurance, a defined contribution plan was operated and funded through payments from the ESM (employer) as well as from the employees to insurance companies. The contributions were recognised as employee benefit expenses when they were due.

Since 1 May 2013, the ESM discontinued the previous arrangement and set up a pension plan with defined contribution characteristics funded through payments to an external insurance company. This insurance scheme also covers the risk of death and disability.

The pension plan is funded by contributions from the ESM (employer) as well as from the employees. The plan is accounted for as a defined contribution plan and corresponding payments are recognised as employee benefit expenses as they fall due.

(b) Termination benefits

Upon termination of employment in certain conditions, a re-settlement allowance is payable to members of staff.

Such termination benefits cannot be reliably estimated. As further described in Note 19, no provision is recognised as at 31 December 2014.

2.17. Taxation

Within the scope of its official activities, the ESM, its assets, income, property and its operations and transactions shall be exempt from all direct taxes under Article 36 of the ESM Treaty. ESM Members have agreed to remit or refund all indirect taxation, subject to certain exceptions under the same provision of the ESM Treaty.

3. RISK MANAGEMENT

This section presents information about the ESM's exposure to and its management and control of risks, in particular the primary risks associated with its use of financial instruments. These are:

- credit risk,
- market risk,
- liquidity and funding risk, and
- operational risk.

Given the nature of the ESM's mandate, where credit risk from lending arises as a result of activities performed in support of beneficiary Member States under a Financial Assistance Facility Agreement, the credit risk in the ESM's lending exposure has to be accepted.

3.1. Risk management organisation

The ESM follows a prudent approach to risk-taking in order to limit potential losses and to ensure continuity in fulfilling its mandate and meeting its commitments.

According to the ESM's High Level Principles for Risk Management the targeted risk appetite should preserve the ESM's funding capacity, ensure the highest creditworthiness and avoid unexpected capital calls. The risk appetite is described in the Risk Policy and is set in the form of a global risk budget quantifying the maximum tolerable potential loss over a defined time horizon with an agreed probability. It covers all financial and non-financial risks of the ESM, and both on- and (if applicable) off-balance sheet items. The risk profile is defined by a set of limits applicable to curtail all types of risks within risk appetite. The ESM does not aim to generate profit on financial support granted to beneficiary Member States and does not provide incentives for speculative exposures in its investment portfolio.

Departments and business functions assume direct responsibility for the day-to-day management of risk. All staff are responsible for ensuring that risks relating to their operations are identified, followed up and reported to the Risk Department. The Risk Department exercises central oversight of risk and ensures a comprehensive and consistent implementation of the risk management framework by all business functions.

The Managing Director bears full accountability for the implementation and functioning of the risk management framework, adequate reporting to the Board of Directors and for further developing the Risk Policy.

The Chief Risk Officer is the head of the Risk Department and is a direct report of the Managing Director. The Chief Risk Officer is responsible and accountable for informing the Managing Director on all risks which the institution may face to ensure enforcement and oversight. The Managing Director, as Chairman of the Board of Directors, reports risk-related information to the Board of Directors, principally through the Board Risk Committee.

To support the implementation of the ESM's risk policies, an Internal Risk Committee (IRC) has been created. The IRC translates the risk appetite into the internal limit structure, which is described in the Risk Policy approved by the Board of Directors. The IRC assists the Board of Directors in ensuring the adequacy of the ESM's internal limit structure and limit setting, providing recommendations on changes of the internal limit structure, on the identification of relevant risks, and on the suitability of methods to monitor and manage them. The IRC conducts on a periodical basis a risk self-assessment and reports the result to the Managing Director.

3.2. Credit risk

Credit risk is defined as the potential for loss arising from the inability of a counterparty, issuer, insurer or other obligor to fulfil its contractual obligations for full value when due. Counterparty risk is considered a particular form of credit risk which derives from the lending and support operations to beneficiary Member States, investment of paid-in capital, placement of possible excess liquidity, and hedging operations. Issuer risk is also a particular form of credit risk that derives from investment in securities of the paid-in capital and excess liquidity.

The inherent risk of non-payment of any beneficiary Member State in relation to loans to euro area Member States is not managed or mitigated by the ESM's risk function. We therefore refer to Note 4 below which further describes the treatment of loans to euro area Member States.

3.2.1. Maximum exposure to credit risk without taking into account of any collateral and other credit enhancements

The following table shows the maximum exposure to credit risk for the components of the balance sheet without taking into account of any collateral and other credit enhancements. For on-balance-sheet positions, these exposures are based on net carrying amounts as reported on the balance sheet.

In €'000	Maximum exposure 31.12.2014	Maximum exposure 31.12.2013
Cash in hand, balances with central banks and post office banks	4,388,003	4,968,640
Loans and advances to credit institutions	18,656,514	22,976,514
Debt securities including fixed-income securities	61,650,424	50,361,775
On balance sheet credit risk exposure	**84,694,941**	**78,306,929**
Off balance sheet items	-	-
Maximum credit risk exposure	**84,694,941**	**78,306,929**

This table does not include the loans and advances to euro area Member States, as the inherent risk of non-payment of the beneficiary Member States is not managed by the Risk function of the ESM, as described in Note 3.2.

3.2.2. Risk profile of counterparties and issuers

The following tables show the breakdown of the financial assets per credit rating. In respect of debt securities including fixed-income securities, the credit ratings of individual issuances (or in the case of short-term securities their long-term rating equivalents) are presented. In case the ratings of issuances are not available the issuers rating is presented. For other financial assets the credit ratings of the counterparties are presented.

These tables do not include the breakdown of the loans and advances to euro area Member States, as the inherent risk of non-payment of the beneficiary Member States is not managed by the risk function of the ESM, as described in Note 3.2.

In €'000	Credit rating*	Clean carrying value as at 31.12.2014
Cash in hand, balances with central banks and post office banks	not rated**	4,386,627
	AA+	1,376
Loans and advances to credit institutions	not rated**	18,655,000
	AA+	1,514
Debt securities including fixed-income securities	not rated**	2,639,676
	AAA	30,442,526
	AA+	12,337,497
	AA	14,940,124
	AA-	1,290,601
Total		**84,694,941**

* Based on the worst rating provided by the major rating agencies (Moody's, Standard & Poor's or Fitch) presented based on the rating scale as used by Fitch.
** "Not rated" means balances placed with Eurosystem central banks and with the Bank for International Settlements, which do not have ratings.

In €'000	Credit rating*	Clean carrying value as at 31.12.2013
Cash in hand, balances with central banks and post office banks	not rated**	4,966,086
	AA+	2,554
Loans and advances to credit institutions	not rated**	22,975,000
	AA+	1,514
Debt securities including fixed-income securities	AAA	23,051,756
	AA+	20,231,283
	AA	7,026,189
	AA-	52,547
Total		**78,306,929**

* Based on the worst rating provided by the major rating agencies (Moody's, Standard & Poor's or Fitch) presented based on the rating scale as used by Fitch.
** "Not rated" means balances placed with Eurosystem central banks, which do not have ratings.

3.2.3. Credit risk on debt securities including fixed-income securities

The ESM invests in assets that fulfil the high credit risk standards as required by the Investment Policy Guideline. To mitigate the credit risk on its investments, the ESM has also established a detailed structure of credit limits. The measurement of credit exposures and the monitoring of limit compliance is performed daily.

3.3. Market risk

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risks could arise from open positions in interest rate and currency products, all of which are exposed to general and specific market movements and changes in the level of volatility of market rates such as interest rates and foreign exchange rates.

3.3.1. Interest rate risk

Interest rate risk is defined as the potential for loss arising from adverse movements in interest rates. The main sources of interest rate risk include asset or liability re-pricing, triggered by covenants or market movements, yield curve shifts, and changes in the funding or lending spread. This risk applies to the paid-in capital investments and may in the future be minimised using interest rate derivatives.

Structural interest rate risk is defined as the risk of a mismatch between the interest rate re-pricing of assets and liabilities on the balance sheet. The current pricing policy for the ESM passes through the cost of funding to beneficiary Member States.

3.3.2. Currency risk

All debt securities issued, and loans and receivables granted to the programme countries, as well as the paid-in capital investments, are denominated in euros. The ESM does not therefore face any currency risk.

3.4. Liquidity risk

The ESM will honour its obligations under its issued debt securities from proceeds that stem from its support programmes, supported by its capital. The ESM monitors its liquidity position on a daily basis in respect of its funding liquidity risk, market liquidity risk and liquidity concentration risk.

Funding liquidity risk is defined as the inability to raise money in a timely manner. Should such a situation arise, the ESM could be unable to settle obligations in a timely fashion and be held in breach of obligations. Funding liquidity risk is managed by maintaining multiple credit lines and investing capital in high-credit-quality liquid assets that can be used to raise cash to meet obligations as they fall due.

Market liquidity risk is defined as the potential for loss arising from a position that cannot easily be unwound or offset at short notice without significantly and negatively influencing the market price because of inadequate market depth or market disruption. Market liquidity risk is minimised by investing capital in high credit quality liquid assets, ensuring the ESM does not hold a significant proportion of a security issuance and adopting adequate measurements that allow the timely detection of liquidity deteriorations.

Liquidity concentration risk is defined as the potential loss arising from concentrations in assets and liabilities as major sources of liquidity. A concentration in assets can disrupt an institution's ability to generate cash in times of illiquidity or reduced market liquidity for certain asset classes. A liability concentration (or funding concentration) exists when the funding structure of the institution makes the ESM vulnerable to a single event or a single factor, such as a significant and sudden withdrawal of funds or inadequate access to new funding. Liquidity concentration risk is minimised by securing credit lines and adopting a diversified funding strategy.

The following tables analyse the ESM's financial assets and liabilities and the shareholders' equity by maturity on the basis of the period remaining between the balance sheet date and the contractual maturity date.

As at 31 December 2014 in €'000	**Less than 3 months**	**From 3 months to 1 year**	**From 1 to 5 years**	**More than 5 years**	**Total**
ASSETS					
Cash in hand, balances with central banks and post office banks	4,388,003	-	-	-	**4,388,003**
Loans and advances to credit institutions	9,656,514	9,000,000	-	-	**18,656,514**
Loans and advances to euro area Member States	-	-	-	45,421,460	**45,421,460**
Debt securities including fixed-income securities	4,315,634	9,031,116	45,066,574	3,237,100	**61,650,424**
Prepayments and accrued income	245,963	349,098	-	-	**595,061**
Total financial assets	**18,606,114**	**18,380,214**	**45,066,574**	**48,658,560**	**130,711,462**
LIABILITIES					
Debt securities in issue	8,428,974	15,832,358	14,946,159	9,956,117	**49,163,608**
Other liabilities	23,591	-	-	-	**23,591**
Accruals and deferred income	77,752	59,603	132,869	3,143	**273,367**
Total financial liabilities	**8,530,317**	**15,891,961**	**15,079,028**	**9,959,260**	**49,460,566**
Shareholders' equity*	-	-	-	81,254,429	**81,254,429**
Total shareholders' equity**	-	-	-	**81,254,429**	**81,254,429**
Net of financial position	**10,075,797**	**2,488,253**	**29,987,546**	**(42,555,129)**	**(3,533)**

As at 31 December 2013 in €'000	**Less than 3 months**	**From 3 months to 1 year**	**From 1 to 5 years**	**More than 5 years**	**Total**
ASSETS					
Cash in hand, balances with central banks and post office banks	4,968,640	-	-	-	**4,968,640**
Loans and advances to credit institutions	11,226,514	11,750,000	-	-	**22,976,514**
Loans and advances to euro area Member States	-	-	-	45,933,000	**45,933,000**
Debt securities including fixed-income securities	8,805,165	13,028,663	26,974,414	1,553,533	**50,361,775**
Prepayments and accrued income	178,530	282,124	-	-	**460,654**
Total financial assets	**25,178,849**	**25,060,787**	**26,974,414**	**47,486,533**	**124,700,583**
LIABILITIES					
Debt securities in issue	11,778,544	22,943,538	22,344,768	2,959,591	**60,026,441**
Other liabilities	21,898	933	-	-	**22,831**
Accruals and deferred income	10,046	54,677	131,271	33,118	**229,112**
Total financial liabilities	**11,810,488**	**22,999,148**	**22,476,039**	**2,992,709**	**60,278,384**
Shareholders' equity*	-	-	-	64,425,271	**64,425,271**
Total shareholders' equity**	-	-	-	**64,425,271**	**64,425,271**
Net of financial position	**13,368,361**	**2,061,639**	**4,498,375**	**(19,931,447)**	**(3,072)**

* Excluding subscribed capital unpaid and subscribed capital called but not paid.
** The shareholder's equity has no defined maturity.

3.5. Operational risk

Operational risk is defined as the potential loss and/or the inability of the ESM to fulfil its mandate resulting from inadequate or failed internal processes, people and systems or from external events. Operational risks are categorised in line with the guidance by the Basel Committee on Banking Supervision, as follows:

- execution, delivery and process management;
- counterparts, products and business practices;
- fraud;
- business continuity and system failures;
- employment practices and workplace safety;
- damage to physical assets.

Management has no tolerance for material operational risks, including those originated through third party/vendor engagements, which may result in the inability of the ESM to effectively fulfil its mandate, or in significant loss and/or reputational damage. No actual operational risk losses were identified in 2014.

All departments are responsible for proactive mitigation of operational risks and for the robustness of the controls in their processes. If specific operational risk events occur, these are reported to an internal operational risk register. Formal escalation procedures have been established involving the Internal Risk Committee and the Board Risk Committee to ensure the active involvement of senior management and, where necessary, the Board of Directors in addressing operational risk issues. All departments, with support from the Operational Risk function, perform a root-cause analysis of operational risk events and implement improvements in the underlying processes and controls to reduce the probability of re-occurrence. This approach is complemented by an annual self-assessment of the top operational risks of the ESM (based on likelihood and potential impact), which are reviewed and monitored by the Internal Risk Committee.

4. CREDIT RISK IN RELATION TO LOANS TO EURO AREA MEMBER STATES

The ESM, as per its mandate, grants financial assistance to euro area Member States experiencing severe financial problems, if indispensable to safeguard the financial stability of the euro area as a whole and of its members. The assistance, therefore, aims at providing financial support according to rules that differ from those of financial markets, given that the overall aim is to support the beneficiary Member State's return to public financial stability.

The determination of debt sustainability and the close monitoring and conditionality attached to all financial assistance to beneficiary Member States, as negotiated with the European Commission in liaison with the European Central Bank (ECB) and whenever possible the IMF, addresses and mitigates credit risk. It is the mutual understanding of the ESM Members that ESM loans enjoy preferred creditor status that is similar to the IMF, while accepting preferred creditor status of the IMF over the ESM. This does not, however, apply to financial assistance in the form of ESM loans following a European financial assistance programme that existed when the ESM Treaty was signed (as at 31 December 2014 this applies to the financial assistance granted to Spain). The ESM has implemented an early warning procedure as requested by the ESM Treaty to monitor the ability of the beneficiary Member State to repay its obligations.

The ESM provided financial assistance to Spain for the recapitalisation of its financial sector which must be repaid by 2027. It is currently providing financial assistance to Cyprus, which is implementing a macroeconomic adjustment programme. Note 7 provides a breakdown of all disbursed amounts, as well as the movements during the period.

From an investor's point of view, the ESM's capital structure and the possibility of capital calls address the risk arising from beneficiary Member States' non-payment and potential losses from other risks. Under Article 9 of the ESM Treaty there are two different instances when a capital call can be made to cover losses or avert non-payment, as described in Note 15.

A capital call to replenish paid-in capital can be made to cover any losses in paid-in capital due to a non-payment by a beneficiary Member and if losses occurring due to other factors would lead to the reduction in the countervalue of the paid-in capital below the threshold of 15% of the maximum lending volume of the ESM.

Furthermore, an emergency capital call would be made if needed to avoid default of an ESM payment obligation to its creditors.

These mechanisms provide the strongest possible assurance that ESM debt securities will always be serviced and repaid.

5. CASH IN HAND, BALANCES WITH CENTRAL BANKS AND POST OFFICE BANKS (IN €'000)

The composition of cash in hand, balances with central banks and post office banks is as follows:

	31.12.2014	31.12.2013
Current account balances with central banks	4,386,627	4,966,086
Current account balances with other banks	1,376	2,554
Total cash in hand, balances with central banks and post office banks	**4,388,003**	**4,968,640**

6. LOANS AND ADVANCES TO CREDIT INSTITUTIONS (IN €'000)

The following table shows the breakdown of the other loans and advances to credit institutions:

	31.12.2014	31.12.2013
Money market deposits	18,655,000	22,975,000
Other deposits	1,514	1,514
Total loans and advances to credit institutions	**18,656,514**	**22,976,514**

At the balance sheet date, the money market deposits contain exclusively money market deposits with central banks of the Eurozone.

Other deposits consist entirely of the lease guarantee deposit in relation to the ESM rental agreement.

7. LOANS TO EURO AREA MEMBER STATES (IN €'000)

The following table shows the geographical breakdown of loans per financial assistance programme and by borrowing country:

	Nr. of loans	Nominal amount	Clean carrying value as at 31 December 2014
Loans to euro area Member States			
- to Spain	6	39,721,460	39,721,460
- to Cyprus	7	5,700,000	5,700,000
Total	**13**	**45,421,460**	**45,421,460**

	Nr. of loans	Nominal amount	Clean carrying value as at 31 December 2013
Loans to euro area Member States			
- to Spain	6	41,333,000	41,333,000
- to Cyprus	4	4,600,000	4,600,000
Total	**10**	**45,933,000**	**45,933,000**

The following table shows the movements of the loans to euro area Member States during 2013 and 2014:

Balance as at 1 January 2013	**39,461,824**
New disbursements	6,465,000
- to Spain	*1,865,000*
- to Cyprus	*4,600,000*
Premiums/discounts amortization	6,176
Balance as at 31 December 2013	**45,933,000**
Balance as at 1 January 2014	**45,933,000**
New disbursements	1,100,000
- to Cyprus	*1,100,000*
Early repayments	(1,611,540)
- from Spain	*(1,611,540)*
Balance as at 31 December 2014	**45,421,460**

8. DEBT SECURITIES INCLUDING FIXED-INCOME SECURITIES

The following table shows the details of the debt securities valuation and their classification as at 31 December 2014:

In €'000	Clean amortised cost	Unrealised gains	Clean fair (carrying) value	Nominal amount
Paid-in capital portfolio	61,058,497	512,858	61,571,355	59,415,262
Fee investments	79,064	5	79,069	78,170
Transitional investment portfolio	-	-	-	-
Total	**61,137,561**	**512,863**	**61,650,424**	**59,493,432**

The following table shows the details of the debt securities valuation and their classification as at 31 December 2013:

In €'000	Clean amortised cost	Unrealised losses	Clean fair (carrying) value	Nominal amount
Paid-in capital portfolio	41,412,128	(110,983)	41,301,145	40,298,126
Transitional investment portfolio	9,065,363	(4,733)	9,060,630	9,066,900
Total	**50,477,491**	**(115,716)**	**50,361,775**	**49,365,026**

As at 31 December 2014, the clean amortised cost of the debt securities is €61,137.6 million (31 December 2013: €50,477.5 million), against a clean fair value of €61,650.4 million (31 December 2013: €50,361.8 million). The difference represents the unrealised result and is recognised directly in the equity within the fair value reserve.

In respect of the paid-in capital portfolio within debt securities including fixed-income securities, the ESM has an established investment policy setting strict investment guidelines that focus on issuers with the highest credit standing in euro and includes a limit structure to mitigate the maximum exposure per counterparty. The transitional investment portfolio was temporary and expired in November 2014. Regarding the fee investments, see Note 2.6.3.

As at 31 December 2014, the debt securities including fixed income securities of the paid-in capital investments include securities that are not listed on regulated markets with a total clean fair value of €10,973.6 million (31 December 2013: of €13,346.1 million). Their fair values are determined using valuation techniques, as disclosed in Note 2.6.5. All other securities are listed on regulated markets and the fair values of these assets are determined based on quoted market prices.

Debt securities including fixed-income securities include debt securities issued by public bodies and debt securities issued by other issuers. Public bodies cover central banks, central governments, regional governments, local governments, supranational institutions and governmental agencies. As at 31 December 2014, debt securities issued by public bodies amounted to €55,518.2 million (31 December 2013: €46,762.4 million), while debt securities issued by other borrowers amounted to €6,132.2 million (31 December 2013: €3,599.4 million). The figures relating to the split between public bodies and other borrowers for debt securities including fixed-income securities have been reclassified for 31 December 2013 to ensure comparability with the figures for the year ended 31 December 2014.

9. INTANGIBLE ASSETS (IN €'000)

The following table shows the movements of the intangible assets during 2014:

	Software	Total intangible assets
Historical cost		
Balance as at 1 January 2014	186	**186**
Additions and disposals (net)	21	**21**
Balance as at 31 December 2014	**207**	**207**
Accumulated amortisation		
Balance as at 1 January 2014	(58)	**(58)**
Amortisation	(63)	**(63)**
Balance as at 31 December 2014	**(121)**	**(121)**
Net book value		
Balance as at 31 December 2014	**86**	**86**
Balance as at 31 December 2013	**128**	**128**

10. TANGIBLE ASSETS (IN €'000)

The following table shows the movements of the tangible assets during 2014:

	Fixtures and fittings	Furniture and office equipment	Total tangible assets
Historical cost			
Balance as at 1 January 2014	2,217	1,215	**3,432**
Additions and disposals (net)	947	255	**1,202**
Balance as at 31 December 2014	**3,164**	**1,470**	**4,634**
Accumulated depreciation			
Balance as at 1 January 2014	(248)	(240)	**(488)**
Depreciation	(329)	(370)	**(699)**
Balance as at 31 December 2014	**(577)**	**(610)**	**(1,187)**
Net book value			
Balance as at 31 December 2014	**2,587**	**860**	**3,447**
Balance as at 31 December 2013	**1,969**	**975**	**2,944**

11. PREPAYMENTS AND ACCRUED INCOME (IN €'000)

The following table shows the breakdown of the prepayments and accrued income:

	31.12.2014	31.12.2013
Interest receivable on:		
- Debt securities including fixed-income securities	456,526	404,035
- Loans and advances to euro area Member States	59,708	31,732
- Loans and advances to credit institutions	6,024	6,199
Amounts charged to the EFSF for administrative services (Note 18/21)	38,260	17,010
Commitment fee receivable	34,252	1,184
Prepayments	291	494
Total prepayments and accrued income	**595,061**	**460,654**

12. DEBTS EVIDENCED BY CERTIFICATES (IN €'000)

The following table discloses the details of debt securities in issue outstanding as at 31 December 2014, together with the coupon rates and due dates.

Financial assistance programme	ISIN code	Nominal amount	Issue date	Maturity date	Coupon
Cyprus	EU000A1U98Y4	1,500,000	27/09/2013	27/03/2015	6M Euribor - 21 bps
Spain	EU000A1U98W8	12,000,000	11/12/2012	11/12/2015	6M Euribor - 6 bps
Spain	EU000A1U98X6	1,865,000	05/02/2013	05/08/2015	6M Euribor - 15 bps
Long-term Funding	EU000A1U98Z1	7,000,000	15/10/2013	15/10/2018	1.25%
Long-term Funding	EU000A1U9803	3,000,000	20/11/2013	20/11/2023	2.125%
Long-term Funding	EU000A1U9811	6,000,000	04/03/2014	04/03/2021	1.375%
Long-term Funding	EU000A1U9829	3,000,000	14/05/2014	15/10/2019	0.875%
Long-term Funding	EU000A1U9803**	990,750	27/06/2014	20/11/2023	2.125%
Short-term Funding	EU000A1U98G1	1,490,000	24/07/2014	22/01/2015	N/A*
Short-term Funding	EU000A1U98J5	1,489,700	21/08/2014	19/02/2015	N/A*
Short-term Funding	EU000A1U98L1	983,750	18/09/2014	19/03/2015	N/A*
Short-term Funding	EU000A1U98M9	998,150	09/10/2014	08/01/2015	N/A*
Short-term Funding	EU000A1U98N7	972,000	23/10/2014	23/04/2015	N/A*
Short-term Funding	EU000A1U9837	4,000,000	28/10/2014	28/10/2016	N/A*
Short-term Funding	EU000A1U98P2	972,250	06/11/2014	05/02/2015	N/A*
Short-term Funding	EU000A1U98Q0	995,000	20/11/2014	21/05/2015	N/A*
Short-term Funding	EU000A1U9837**	987,500	27/11/2014	28/10/2016	N/A*
Short-term Funding	EU000A1U98R8	994,800	04/12/2014	05/03/2015	N/A*
Total		**49,238,900**			

* Zero-coupon bond.
** Tap issue.

The following table discloses the details of debt securities in issue outstanding as at 31 December 2013, together with the coupon rates and due dates.

Financial assistance programme	ISIN code	Nominal amount	Issue date	Maturity date	Coupon
Cyprus	EU000A1U98Y4	1,500,000	27/09/2013	27/03/2015	6M Euribor - 21 bps
Spain	EU000A1U98X6	1,865,000	05/02/2013	05/08/2015	6M Euribor - 15 bps
Spain	EU000A1U98U2	6,500,000	11/12/2012	11/06/2014	6M Euribor - 12 bps
Spain	EU000A1U98V0	12,000,000	11/12/2012	11/12/2014	6M Euribor - 12 bps
Spain	EU000A1U98W8	12,000,000	11/12/2012	11/12/2015	6M Euribor - 6 bps
Long-term Funding	EU000A1U9803	3,000,000	20/11/2013	20/11/2023	2.125%
Long-term Funding	EU000A1U98Z1	7,000,000	15/10/2013	15/10/2018	1.25%
Short-term Funding	EU000A1U9720	1,996,650	05/12/2013	06/03/2014	N/A*
Short-term Funding	EU000A1U9712	1,983,600	21/11/2013	22/05/2014	N/A*
Short-term Funding	EU000A1U9704	1,972,300	07/11/2013	06/02/2014	N/A*
Short-term Funding	EU000A1U97Z3	2,461,000	24/10/2013	24/04/2014	N/A*
Short-term Funding	EU000A1U97Y6	1,989,700	03/10/2013	09/01/2014	N/A*
Short-term Funding	EU000A1U97X8	2,442,100	19/09/2013	20/03/2014	N/A*
Short-term Funding	EU000A1U97V2	1,441,800	22/08/2013	20/02/2014	N/A*
Short-term Funding	EU000A1U97T6	1,937,000	25/07/2013	23/01/2014	N/A*
Total		**60,089,150**			

* Zero-coupon bond.

The following table shows the movements of the debt securities in issue during 2013 and 2014:

Balance as at 1 January 2013	**39,461,824**
Issuance during the period	63,400,091
Maturities during the year	(42,847,200)
Premiums/discounts amortization	11,726
Balance as at 31 December 2013	**60,026,441**

Balance as at 1 January 2014	**60,026,441**
Issuance during the period	53,443,958
Maturities during the year	(64,334,450)
Premiums/discounts amortization	27,659
Balance as at 31 December 2014	**49,163,608**

All debt securities in issue as at 31 December 2013 and 31 December 2014 are issued under English law as the governing law.

13. OTHER LIABILITIES

As at 31 December 2014, the other liabilities are entirely composed of supplier's invoices which are not yet settled amounting to €23.6 million (31 December 2013: €22.8 million), from which €14.8 million (31 December 2013: €14.8 million) is against the EFSF.

14. ACCRUALS AND DEFERRED INCOME (IN €'000)

The following table shows the breakdown of the accruals and deferred income:

	31.12.2014	31.12.2013
Interest payable on debts evidenced by certificates	103,774	31,928
Deferred income on up-front service fee	169,593	197,184
Total accruals and deferred income	**273,367**	**229,112**

As explained in Note 2.3., the amortisation of the up-front service fee is recognised in the profit-and-loss account on a linear basis under interest receivable and similar income on loans to euro area Member States.

15. SUBSCRIBED CAPITAL

In €'000	Subscribed capital	Subscribed, uncalled capital	Subscribed, called capital
At 1 January 2013	**700,000,000**	**(620,000,000)**	**80,000,000**
Subscription to the authorised capital	-	-	-
Authorised capital calls	-	-	-
At 31 December 2013	**700,000,000**	**(620,000,000)**	**80,000,000**

In €'000	Subscribed capital	Subscribed, uncalled capital	Subscribed, called capital
At 1 January 2014	**700,000,000**	**(620,000,000)**	**80,000,000**
Subscription to the authorised capital	1,935,300	(1,935,300)	-
Authorised capital calls	-	221,200	**221,200**
At 31 December 2014	**701,935,300**	**(621,714,100)**	**80,221,200**

On 31 December 2014, the ESM's shareholders were the 18 euro area Member States. The contribution key for subscribing to the ESM authorised capital is based on the key for subscription, by the national central banks of the ESM Members, of the ECB's capital.

Latvia joined the ESM on 13 March 2014 and subscribed to an authorised capital of 19,353 shares with a par value of €100,000 each, representing €1,935.3 million of subscribed capital of which €221.2 million was called. As at 31 December 2014 Latvia had made a first instalment for the payment of paid-in shares in the amount of €44.2 million.

On 31 December 2014, the authorised capital is €701.9 billion (31 December 2013: €700.0 billion), divided into 7,019,353 shares (31 December 2013: 7,000,000 shares), with a par value of €100,000 each, and is split according to the contribution key. Out of the total authorised capital, €621.7 billion (31 December 2013: €620.0 billion) is callable. On 31 December 2014, the called subscribed capital amounted to €80.2 billion (31 December 2013: €80.0 billion), of which €80.0 billion (31 December 2013: €64.3 billion) is paid.

In the subsequent financial period, on 3 February 2015, Lithuania joined the ESM and became its 19th Member. Lithuania's capital subscription will be €2.86 billion, including €327.2 million in paid-in capital. The payment of paid-in capital will be made in five annual instalments of €65.4 million each.

ESM Members as at 31 December 2014	ESM Key (%)	Number of shares	Subscribed capital (in €'000)	Subscribed capital called and paid (in €'000)
Federal Republic of Germany	27.0716	1,900,248	190,024,800	21,717,120
French Republic	20.3297	1,427,013	142,701,300	16,308,720
Italian Republic	17.8643	1,253,959	125,395,900	14,330,960
Kingdom of Spain	11.8709	833,259	83,325,900	9,522,960
Kingdom of the Netherlands	5.7012	400,190	40,019,000	4,573,600
Kingdom of Belgium	3.4675	243,397	24,339,700	2,781,680
Hellenic Republic	2.8089	197,169	19,716,900	2,253,360
Republic of Austria	2.7757	194,838	19,483,800	2,226,720
Portuguese Republic	2.5023	175,644	17,564,400	2,007,360
Republic of Finland	1.7924	125,818	12,581,800	1,437,920
Ireland	1.5878	111,454	11,145,400	1,273,760
Slovak Republic	0.8217	57,680	5,768,000	659,200
Republic of Slovenia	0.4264	29,932	2,993,200	342,080
Republic of Latvia	0.2757	19,353	1,935,300	44,240
Grand Duchy of Luxembourg	0.2497	17,528	1,752,800	200,320
Republic of Cyprus	0.1957	13,734	1,373,400	156,960
Republic of Estonia	0.1855	13,020	1,302,000	148,800
Malta	0.0729	5,117	511,700	58,480
Total	**100.00**	**7,019,353**	**701,935,300**	**80,044,240**

As at 31 December 2014 the subscribed capital called but not paid amounts to €177.0 million (31 December 2013: €15,712.4 million).

On 30 April 2014, the 17 euro area Member States which established the ESM completed their scheduled payments of paid-in capital. The fifth and final tranche transferred to the ESM amounted to €15.7 billion. The ESM has thus achieved its target level of paid-in capital of €80 billion. The remaining €177.0 million is Latvia's yet unpaid amount.

There are three different instances when a capital call can be made, in accordance with Article 9 of the ESM Treaty.

i. A general capital call under Article 9(1) of the ESM Treaty concerns payment of the initial capital and an increase of paid-in capital that could be necessary, for example, to raise the lending capacity. To initiate such a call, the Managing Director of the ESM, would make a proposal to the Board of Governors outlining the objective of such a call, the amounts and contributions for each shareholder and a proposed payment schedule. The Board of Governors, by mutual agreement, may call in authorised capital at any time.

ii. A capital call under Article 9(2) of the ESM Treaty to replenish paid-in capital could happen for two reasons:

- to cover a shortfall due to a non-payment by a beneficiary country and,
- if losses occurring due to other factors lead to the reduction in the countervalue of the paid-in capital below the threshold of 15% of the maximum lending volume of the ESM.

The Managing Director would make a proposal to the Board of Directors, which would specify the losses incurred and the underlying reasons. A simple majority of the Board of Directors is required to agree to call in capital under these circumstances.

iii. An emergency capital call, under Article 9(3) of the ESM Treaty, would be used for the acceleration of the paid-in capital during the ramp-up period to comply with the requested capital ratio and to avoid default of an ESM payment obligation to its creditors.

The Managing Director has the responsibility to make such a capital call to ESM shareholders if there were a risk of default. As stated in the ESM Treaty, the ESM shareholders have irrevocably and unconditionally undertaken to pay on demand such a capital within seven days of receipt of the demand.

If an ESM member fails to meet the required payment under a capital call made pursuant to Article 9(2) or (3), a revised increased capital call would be made to all ESM Members by increasing the contribution rate of the remaining ESM Members on a pro-rata basis, according to Article 25 (2) of the ESM Treaty. When the ESM Member which failed to contribute settles its debt to the ESM, the excess capital is returned to the other ESM Members.

16. RESERVE FUND

As foreseen by Article 24 of the ESM Treaty the Board of Governors shall establish a reserve fund and, where appropriate, other funds. Without prejudice to the distribution of dividends pursuant to Article 23 of the ESM Treaty, the net income generated by the ESM operations and the proceeds of possible financial sanctions received from the ESM Members under the multilateral surveillance procedure, the excessive deficit procedure and the macro-economic imbalances procedure established under the Treaty on the Functioning of the European Union (TFEU) are put aside in a reserve fund, in accordance with Chapter 5 of the ESM Treaty. The primary purpose of the reserve fund is the absorption of potential losses.

On 19 June 2014, the Board of Governors decided at their annual general meeting to establish the reserve fund and to appropriate the accumulated net result of the previous financial periods amounting to €253.4 million to the reserve fund. This amount also represents the outstanding balance of the reserve fund as at 31 December 2014.

17. INTEREST RECEIVABLE AND SIMILAR INCOME ON LOANS AND ADVANCES TO EURO AREA MEMBER STATES (IN €'000)

Interest receivable and similar income on loans and advances to euro area Member States are detailed as follows:

	2014	2013
Interest on loans (*)	432,265	236,859
Amortisation up-front service fee	33,091	30,936
Commitment fee	34,252	1,184
Total interest and similar income	**499,608**	**268,979**

(*) The interest on loans comprises base rate interest representing the cost of funding of the ESM, the margin and the annual service fee as they are all defined in the ESM Pricing Policy.

18. OTHER OPERATING INCOME

The EFSF has asked the ESM to provide administrative and other support services to assist it in performing its activities. To formalise this cooperation, the ESM and EFSF entered into a service level agreement from 1 January 2013.

Under the agreement's terms, the ESM is entitled to charge the EFSF service fees to achieve a fair cost-sharing arrangement. For the services during the financial year 2014, the ESM charged the EFSF €21.3 million (2013: €17.0 million). The amount had yet to be paid at balance sheet date (refer to Note 11).

19. STAFF COSTS

Staff costs are detailed as follows (in €'000):

	2014	2013
Salaries and allowances	13,501	10,292
Social security costs	678	477
Pension costs	4,969	3,196
Total staff costs	**19,148**	**13,965**

The ESM employed 122 persons as at 31 December 2014 (102 as at 31 December 2013).

In addition to its own employees, the ESM has expenses for employees seconded from other International Financial Institutions, as well as interim and temporary staff hired from external agencies. The related cost amounts to €1.1 million for the 2014 financial year (2013: €1.0 million) and are accounted for as other administrative expenditures (refer to Note 20).

Upon termination of employment, a re-settlement allowance may be paid and the payment of this benefit is subject to several criteria, as described in Note 2.16. Taking into account the complex structure of termination benefits and the fact that the ESM has no historical data to estimate the occurrence of such events, no provision is recognised as at 31 December 2014 and 31 December 2013.

20. OTHER ADMINISTRATIVE EXPENDITURES (IN €'000)

Other administrative expenditures consist of fees paid for professional services and miscellaneous operating expenses and are detailed as follows:

	2014	2013
Outsourced services (mainly IT, HR and accounting services)	6,161	4,008
Treasury related services	3,808	1,752
Advisory services	3,315	5,033
Rental and related services	2,831	1,104
Interim and secondment fees (Note 19)	1,088	1,239
Legal services	851	908
Rating agencies fees	359	814
Other services	3,348	2,018
Total other administrative expenditures	**21,761**	**16,876**

21. RELATED-PARTY TRANSACTIONS

Key management

The ESM has identified members of the Board of Governors, Board of Directors and the Management Board as key management personnel.

The members of the Board of Governors and the Board of Directors were not entitled to remuneration during the period.

Transactions with shareholders

The ESM granted loans to Spain and Cyprus, which are also shareholders of the ESM, as disclosed in more detail in Note 7. In the course of its investment activity, the ESM purchases debt securities issued by its shareholders. Such securities are reported as debt securities including fixed-income securities on the balance sheet.

Transactions with the European Financial Stability Facility (EFSF)

The EFSF is a public limited liability company (Société Anonyme) incorporated under Luxembourg law on 7 June 2010 following decisions taken by the euro area Member States on 9 May 2010 within the framework of the Ecofin Council. The EFSF's mandate is to safeguard financial stability in Europe by providing financial assistance to euro area Member States within the framework of a macro-economic adjustment programme.

The EFSF was created as a temporary rescue mechanism. In accordance with its Articles of Association, the EFSF will be dissolved and liquidated when all financial assistance provided to euro area Member States and all funding instruments issued by the EFSF have been repaid in full. Since 1 July 2013, the EFSF may no longer engage in new financing programmes or enter into new loan facility agreements.

External expenses incurred by the EFSF in relation to establishing and running the ESM were recharged by the EFSF to the ESM, together with other non-expense related items. The total amount of items recharged to the ESM, and recognised as expense in 2012, in an amount of €14.8 million had not yet been paid at balance sheet date (refer to Note 13).

The EFSF has asked the ESM to provide certain administrative services and other support services to facilitate the performance of its activities. To formalise this cooperation, the two organisations entered into a service level agreement. The ESM charged the EFSF €21.3 million for the financial year 2014, and €17.0 million for the financial year 2013, which had not yet been paid at balance sheet date (refer to Note 11) under the terms of the Agreement. The ESM recognised these amounts as other operating income in the profit and loss account.

On a temporary basis, the ESM invested in short term notes issued by the EFSF, as disclosed in Note 2.6.4. and in Note 8. The transitional investment portfolio was of temporary nature and expired in November 2014. During 2014 the highest outstanding amount of the transitional investment portfolio was €16.9 billion.

22. AUDIT FEE (IN €'000)

The total fees accrued are presented as follows:

	2014	**2013**
Audit fees	240	261
Total Audit fees	**240**	**261**

23. OFF-BALANCE SHEET ITEMS

As at 31 December 2014, the off-balance sheet items represent the undisbursed part of €3.3 billion (31 December 2013: €4.4 billion) for the financial assistance programme to Cyprus of up to €9 billion.

Any further disbursement is subject to conditionality in line with the Memorandum of Understanding attached to the Financial Assistance Facility Agreement.

On 31 December 2013, the €100 billion financial assistance programme to Spain expired and as a result, any remaining undisbursed funds were automatically cancelled.

24. EVENTS AFTER THE REPORTING PERIOD

Except for those included in the notes to the financial statements, there have been no material post balance sheet events which could require disclosure or adjustment to the 31 December 2014 financial statements.

05.

EXTERNAL AUDITOR'S REPORT ON THE 2014 FINANCIAL STATEMENTS

To the Board of Governors of the European Stability Mechanism

Luxembourg, 27 March 2015

We have audited the accompanying financial statements of European Stability Mechanism, which comprise the balance sheet as at 31 December 2014, the profit and loss account, the statement of changes in equity and the statement of cash flows for the year then ended and a summary of significant accounting policies and other explanatory information.

BOARD OF DIRECTORS' RESPONSIBILITY FOR THE FINANCIAL STATEMENTS

The Board of Directors is responsible for the preparation and fair presentation of these financial statements in accordance with the general principles of the Directive 86/635/EEC of the Council of the European Communities of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions, as amended by Directive 2001/65/EC of 27 September 2001, by Directive 2003/51/EC of 18 June 2003 and by Directive 2006/46/EC of 14 June 2006 ("the Directives"), and for such internal control as the Board of Directors determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

RESPONSIBILITY OF THE "RÉVISEUR D'ENTREPRISES AGRÉÉ"

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing as adopted for Luxembourg by the "Commission de Surveillance du Secteur Financier". Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the judgment of the "Réviseur d'entreprises agréé", including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the "Réviseur d'entreprises agréé" considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the Board of Directors, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

OPINION

In our opinion, the financial statements give a true and fair view of the financial position of European Stability Mechanism as of 31 December 2014, and of the results of its operations and its cash flows for the year then ended in accordance with the general principles of the Directives.

PricewaterhouseCoopers,
Société coopérative

Represented by

Pierre Krier

06.

REPORT OF THE BOARD OF AUDITORS ON THE 2014 FINANCIAL STATEMENTS

Luxembourg, 31 March 2015

The Board of Auditors of the European Stability Mechanism (ESM) was set up pursuant to Article 30 of the Treaty establishing the ESM and Article 24 of the ESM By-Laws. The Board of Auditors is independent from the Board of Directors and its members are appointed directly by the Board of Governors.

The Board of Auditors carries out independent audits of regularity, compliance, performance and risk management of the ESM, inspects the ESM accounts, and monitors and reviews the ESM's internal and external audit processes and results. Information on the audit work of the Board of Auditors, its audit findings, conclusions and recommendations for the year ended December 2014 are included in the annual report, which has been prepared in accordance with Article 24(6) of the ESM By-Laws and submitted to the Board of Governors.

This Board of Auditors´ report on the financial statements is addressed to the Board of Governors in accordance with Article 23(2)(d) of the ESM By-Laws. It is delivered in respect of the financial statements of the ESM for the year ended 31 December 2014.

In 2014 the ESM has made further progress in design and implementation of internal, operational and managerial controls. The institution is still in the process of introducing a comprehensive integrated controls framework that should finally enable ESM Management to confirm the adequacy and effectiveness of the internal controls as a whole. The Board of Auditor notes that, to the best of its judgment, no other material matters have come to its attention that would prevent it from recommending that the Board of Governors approve the ESM financial statements for the year ended 31 December 2014.

On behalf of the Board of Auditors

Ulrich Graf
Chairperson

Acronyms and abbreviations

ALM	Asset and Liability Management
AQR	Asset Quality Review
Bps	Basis points
BRRD	Bank Recovery and Resolution Directive
CDS	Credit Default Swap
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
DMO	Debt Management Office
DRI	Direct Recapitalisation Instrument
EBA	European Banking Authority
EBS	(Deutsche Bundesbank's) ESM Bidding System
EC	European Commission
ECB	European Central Bank
ECCL	Enhanced Conditions Credit Line
EFSF	European Financial Stability Facility
EMU	Economic and Monetary Union
ESM	European Stability Mechanism
ESMAT	Administrative Tribunal of the European Stability Mechanism
ESRB	European Systemic Risk Board
EU	European Union
EWS	Early Warning System
FFA	Financial Assistance Facility Agreement
FROB	(Spanish fund for orderly bank restructuring)
GDP	Gross Domestic Product
GLF	Greek Loan Facility
HICP	Harmonised Index of Consumer Prices
IMF	International Monetary Fund
IRC	Internal Risk Committee
LTRO	Long-Term Refinancing Operation
MoU	Memorandum of Understanding
NPL	Non-Performing Loan
NPV	Net Present Value
OECD	Organisation for Economic Co-operation and Development
OMT	Outright Monetary Transactions
PCCL	Precautionary Conditioned Credit Line
PIC	Paid-in Capital
PSI	Private Sector Involvement
RFA	Regional Financing Arrangement
Sareb	(the Spanish asset management company/bad bank)
SGP	Stability and Growth Pact
SMEs	Small and Medium-sized Enterprises
SMP	Securities Markets Programme
SSA	Sovereign, Supranational and Agency (bond issuers)
SSM	Single Supervisory Mechanism
SRB	Single Resolution Board
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
TIP	Transitional Investment Portfolio
TLTRO	Targeted Longer-Term Refinancing Operations
VaR	Value at Risk
WAM	Weighted-Average Maturity

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European Stability Mechanism

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