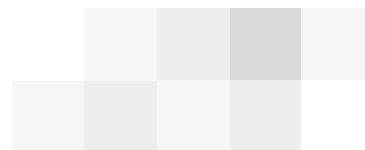




Annual Report

European Stability Mechanism



Introduction to the ESM

The European Stability Mechanism (ESM) is a permanent crisis resolution mechanism established by the countries of the euro area. It is an intergovernmental institution based in Luxembourg, operating since 8 October 2012. The ESM's mission is to provide financial assistance to ESM Members experiencing or threatened by severe financing problems. Such assistance is granted if necessary to safeguard the financial stability of the euro area as a whole and of the ESM Members individually.

The ESM raises funds by issuing debt instruments, which are purchased by institutional investors. The proceeds from this issuance enable the ESM to provide the following types of financial assistance:

- loans to ESM Members to cover their financing needs;
- loans to ESM Members for the purpose of recapitalisation of financial institutions;
- precautionary financial assistance in the form of a credit line: Precautionary Conditioned Credit Line (PCCL) and Enhanced Conditions Credit Line (ECCL);
- the purchase of bonds of an ESM Member in primary and secondary debt markets.

All financial assistance provided by the ESM to its Member States is linked to the implementation of appropriate conditions. These are reforms which are part of a macroeconomic adjustment programme or designed to address the specific imbalances and weaknesses of an ESM Member. The conditionality is laid down in a Memorandum of Understanding concluded by the European Commission, European Central Bank, International Monetary Fund (where applicable) and the beneficiary Member State.

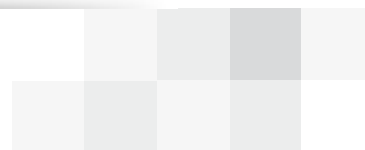
Comprehensive information about the ESM can be found on our website: www.esm.europa.eu

The 2013 ESM Annual Report contains the Financial Statements for the financial year ending 31 December 2013, 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 at 18 May 2014, but all historic financial data there set out is limited to the period to 30 April 2014, unless otherwise stated.

Annual Report

European Stability Mechanism

Table of contents



Message from the Managing Director	6
Letter of Transmittal to the Board of Governors	8
Chapter 1: Economic Developments	10
Europe's crisis response: accomplishments and challenges ahead	10
New economic policies	10
A new model of governance	11
New support mechanisms	12
Strengthening the financial system	12
Conclusion	13
Macroeconomic and financial environment	14
Global rebalancing	14
Structural improvements in the euro area	15
Financial market conditions	16
Risks to the outlook	16
Programme country experiences	17
Cyprus	17
Greece	18
Ireland	19
Portugal	20
Spain	21
Chapter 2: ESM Activities	24
Lending activities	24
Cyprus	24
Spain	25
Funding activities	30
2013 review	30
Outlook for 2014	31
Investment and Treasury	36
Investment Policy	36
Investment and Treasury activities	36
Risk management	38
Nature of ESM activities and key risks	40
Transparency and communication	44
Chapter 3: Institutional Framework and Organisation	45
ESM financial assistance instruments	46
Governance	48
ESM shareholders	48
Governance structure	49
Board of Governors	50
Board of Directors	52
Board of Auditors	54
Internal control	55
Organisation	56
Responsibilities of departments	57
Human resources	58

Chapter 4: ESM Financial Report	60
2013 results	60
Outlook for 2014	61
Financial Statements	62
Chapter 5: External Auditor's Report on the Financial Statements	86
Chapter 6: Board of Auditors' Report on the Financial Statements	88
Glossary	90
Acronyms and abbreviations	94
Boxes	
1. The ESM and the banking union	13
2. Potential savings on EFSF/ESM interest payments	22
3. The ESM/EFSF's Early Warning System	23
4. Restructuring of the Spanish banking sector	27
5. Addressing the challenges of the financial sector in Cyprus	28
6. EFSF extension of maturities for Ireland and Portugal	29
7. Investor relations	34
8. The ESM's credit rating and the regulatory treatment of its issuances	35
9. Investment and Treasury performance	37
10. ESM Administrative Tribunal	59
Charts	
1. Emerging market 10-year sovereign bond yields	14
2. 10-year government bond yields in Germany, France, the Netherlands and United States	14
3. Fiscal balance and 2013-15 forecast, euro area Member States	15
4. Evolution of euro area GDP growth expectations	15
5. Stock prices in the euro area and United States	16
6. Spain, Ireland and Portugal 10-year bond spreads vs Germany	16
7. Composite household borrowing cost in the euro area across all maturities	16
8. Common Equity Tier one of Spanish banks under programme	19
9. Total deposits excluding bailed-in amounts (in Cyprus)	28
10. Total Assets of the Banking sector/GDP	28
11. Irish debt redemption profile	29
12. Portuguese debt redemption profile	29
13. ESM Inaugural issue – Breakdown by region and investor type	30
14. Swap spread of the first two ESM bonds	31
15. ESM Maturity Profile	32
16. EFSF and ESM Maturity Profile	33
Tables	
1. Potential savings of EFSF/ESM financing vs theoretical market cost	22
2. Funds disbursed to Cyprus in 2013	24
3. ESM bonds that fund the Cypriot Bank Recapitalisation	25
4. ESM bonds that fund the Spanish Bank Recapitalisation	25
5. Funds requested by Spain for Group 1 banks	25
6. Split of the funds requested by Spain for Group 1 banks and SAREB	26
7. Funds requested by Spain for Group 2 banks	26
8. Split of the funds requested by Spain for Group 2 banks	26
9. ESM long-term funding targets for 2014	32
10. Daily and annualised VaR comparison, 2012 and 2013	42
11. Shares and subscribed capital per ESM member	48

Message from the Managing Director

Klaus Regling

Managing Director

European Stability Mechanism



If one word can characterise the year 2013 for the European Stability Mechanism (ESM) and the euro area, it is normalisation. While market concerns about the future of the single currency receded, the weaker economies within the euro area kept up the pace of reform and have started to exit their assistance programmes according to plan.

At the end of December, Spain exited its financial sector assistance programme. This successfully concluded the first ESM programme since the institution was founded in October 2012 as the euro area's permanent crisis resolution mechanism. Earlier in December, Ireland completed its macroeconomic adjustment programme with the European Financial Stability Facility (EFSF), the temporary crisis resolution mechanism created in 2010. More recently, in May 2014, Portugal followed the same route, also completing its EFSF programme.

These three successful programme exits indicate that the euro area is about to overcome the crisis. Although the beneficiary countries must continue their efforts, the progress accomplished in Cyprus, Greece, Ireland, Portugal and Spain shows that the strategy is working. The ESM, like the EFSF, provides temporary rescue loans to countries that have lost market access at reasonable interest rates. In exchange, the beneficiary countries commit to strict conditionality. In the case of macroeconomic adjustment programmes, the governments implement structural reforms and budget consolidation. In the case of Spain's financial sector programme, the government committed to sector-specific reforms.

The evolution of economic data shows that these efforts produced the expected results. Countries with an ESM or EFSF programme have reduced their unit labour costs significantly, which in turn has strengthened their competitiveness. As a result, exports are starting to pick up, eliminating the countries' long-standing current account deficits. At the same time, the countries have reduced their budget deficits and, after implementing labour market and other structural reforms, are seeing the first signs of new job creation.

The ESM and EFSF loans provided at very low interest rates and very long maturities demonstrate euro area solidarity at work. These loans enable the governments to stretch the painful economic adjustment over time and so ease the burden on their populations. Simultaneously, all euro area Member States are benefiting from this approach. The reforms in the programme countries, stronger economic policy coordination across the euro area, and the completion of banking union are making the entire currency union more resilient and sustainable.

This strategy is convincing the markets. Investors are rewarding the euro area for its determination in overcoming prior weaknesses with a decline of interest rates on government bonds to below or near pre-crisis levels.

Latvia's accession to the euro area in January 2014 shows that the single currency remains attractive, contradicting the doomsayers, and will continue to grow.

Latvia joined the ESM in March, becoming the organisation's first new member since its inauguration. The ESM's 18th Member provides an example to the euro area. The Baltic country was the first to enter the crisis in 2008. Devaluation was not an option since the Latvian lat was pegged to the euro. As a consequence, Latvia pioneered the strategy of internal devaluation which was later successfully followed by beneficiary countries.

The ESM and EFSF together have so far disbursed €222 billion to the five programme countries. With its two programmes (Spain and Cyprus) the ESM has used €50.3 billion of its maximum lending capacity of €500 billion. The fact that almost 90% of the ESM's financial firepower is unused bears testimony to the euro area's resilience against future crises.

In January 2013, the ESM started its short-term funding programme with bimonthly 3- and 6-month bill auctions. The total amount raised by this programme in 2013 was €50.1 billion. It effectively replaced the EFSF bills programme. In October 2013, the ESM launched its long-term funding programme. With two bond transactions the ESM raised €10 billion in 2013. Throughout the year the EFSF continued to be a very active issuer and it will continue to be so in the years to come.

In April 2014, the ESM received the fifth tranche of paid-in capital from its Members, bringing the total amount to a little more than €80 billion. With this volume, the ESM is today the international financial institution with the strongest capital structure in the world. This paid-in capital assures investors in ESM bills and bonds that the organisation will honour its obligations in any circumstances.

Following an ESM Treaty requirement, in March the Board of Directors endorsed the ESM's proposal to create an Early Warning System. The objective is to determine the ability of the programme countries to repay their loans to the ESM. This requires an assessment of the short-term liquidity position of the government, the country's market access, the fiscal position and the medium- to long-term sustainability of public debt.

As the crisis becomes less acute and weaker economies regain the trust of investors and creditors, the role played by the ESM will evolve; but its responsibility and relevance as the euro area's last line of defence will remain.

Management Board & Heads of Division *European Stability Mechanism*



Letter of Transmittal to the Board of Governors

19 June 2014

Dear Chairperson,

I have the honour to present to the Board of Governors the Annual Report in respect of the financial year 2013, in accordance with Article 23 (2) of the By-Laws of the European Stability Mechanism (hereafter the "By-Laws").

The audited Financial Statements as at 31 December 2013, as drawn up by the Board of Directors on 24 March 2014 under Article 21 of the By-Laws, are presented in Chapter 4. The external audit was reviewed and monitored by the Board of Auditors as required under Article 24 (4) of the By-Laws.

Klaus Regling

Managing Director

ESM Board of Governors

(as of April 2014)



Jeroen Dijsselbloem
Chairperson of the
Board of Governors,
Minister of Finance,
The Netherlands



Koen Geens
Minister of
Finance,
Belgium



Wolfgang Schäuble
Federal Minister
of Finance,
Germany



Jürgen Ligi
Minister of
Finance,
Estonia



Michael Noonan
Minister of
Finance,
Ireland



Giannis Stournaras
Minister of Finance,
Greece



Michel Sapin
Minister of
Finance,
France



Luis de Guindos
Minister of
Finance,
Spain



Pier Carlo Padoan
Minister of
Economy and
Finance,
Italy



Harris Georgiades
Minister of
Finance,
Cyprus



Andris Vilks
Minister of
Finance,
Latvia



Pierre Gramegna
Minister of
Finance,
Luxembourg



Edward Scicluna
Minister of
Finance,
Malta



**Michael
Spindelegger**
Federal Minister of
Finance,
Austria



**Maria Luís
Albuquerque**
Minister of State
and Finance,
Portugal



Uroš Čufer
Minister of
Finance,
Slovenia



Peter Kažimír
Deputy Prime
Minister and
Minister of
Finance,
Slovakia



Jutta Urpilainen
Minister of
Finance,
Finland

Economic Developments

Europe's crisis response: accomplishments and challenges ahead

Europe has come a long way in overcoming the structural sources of the crisis. The great European recession emerged as a consequence of the financial crisis in the United States and home-grown problems in the euro area. The key problems within the euro area were major macroeconomic imbalances in several countries resulting from misaligned policies, a vulnerable banking system, and institutional gaps in the governance structure, which allowed national budgets to be insufficiently prepared to weather a severe economic and financial downturn. Moreover, it became apparent when the crisis unfolded in an unforeseen manner that a second line of defence (a euro-based financial backstop) was missing. These problems were addressed through a comprehensive and consistent set of policies, which is now showing results.

The crisis response of Member States consisted of several policy building blocks. To tackle the disarray in public finances, Member States have implemented significant fiscal consolidation programmes to reduce fiscal deficits and to regain investor confidence. At the same time, countries are implementing key structural reforms which are already laying the foundations for sounder growth, perhaps less buoyant but more sustainable. At the European level, countries have adopted a new and strengthened model of economic governance in the euro area based on tighter coordination of policies. Decisively, financial backstops — the EFSF and ESM — were created

from scratch, preventing the collapse of some euro area economies and filling a significant gap in the architecture of the monetary union. The euro area has also reinforced its banking system, strengthening supervision and prudential regulation. This has laid the ground for a new pillar of integration: the banking union, with the creation of a single supervisory mechanism, a single resolution mechanism, a single resolution fund, and a harmonised system of national deposit guarantee schemes.

New economic policies

The key part of the crisis response has been the efforts at the national level to redress imbalances built up in previous years. A wave of structural reforms has transformed Europe, in particular in programme countries: changes tailored according to the needs of each country, but all geared toward raising competitiveness, employment and growth.

Greece was the country with the largest accumulated imbalances and structural gaps, and therefore required the most extensive programme. The authorities took strong measures to improve the collection of taxes, fiscal management and budget execution. They implemented key reforms with respect to the pension system, labour market and health system. The programme is still ongoing and these implementation efforts must continue to complete the adjustment process and realise the full benefits.

In Portugal, determined action was needed after a decade of low growth. In all key areas of government spending (health, pensions, wages) reforms have underpinned

sustainability. The Portuguese authorities have liberalised gas and energy markets, and adopted a new solvency code and a new corporate restructuring framework, among several other measures. Though the current programme was concluded successfully, the adjustment is not yet over and reforms must be continued to reap all the benefits of the efforts made so far.



Siret Vildo

Banking Sector Expert

Joined the ESM in July 2013

Worked in the European Central Bank as a Financial Stability Expert. Previously worked in the Central Bank of Estonia for six years.

The opportunity to join the ESM and to continue working with countries needing European support was too good to miss, as it enabled me to get another perspective in supporting euro area countries.

In Ireland, where the origin of the crisis was rooted in the banking and housing sectors, there was a need to counter the loss of competitiveness in recent years. EFSF financial assistance has bought time to catch up. The reform agenda placed a particular stress on banking and policies to enhance competition of services and utilities, redesigning incentives for R&D and turning the focus of social support schemes further toward employment.

Cyprus signed up to an economic reform programme with a strong focus on the complete overhaul of the financial sector to ensure its viability at a much reduced level.

Other peripheral euro area economies have also been under pressure from markets. In these countries, which kept market access, economic adjustment is also under way with labour market, pension and tax reforms. Here the pace of reform may be less urgent, but unsustainable policies of the past are being corrected.

As a consequence, the euro area has proved its seriousness about fiscal consolidation, structural reforms and the rebalancing of the economy. All Member States, not only those that were under pressure or with a macroeconomic adjustment programme, have budgetary consolidation paths in place with a clear objective to reach a balanced budget during the next few years. Since 2009,

the average public deficit in the euro area has been roughly halved and in economies under programmes the correction was greater. Countries in this latter group have also reversed the loss of competitiveness of the last decade by consistently reducing their nominal unit labour costs. In addition, economies driven by unsustainable consumption levels saw a strong deleveraging, which managed to put a halt to a long record of large current account deficits.

A demonstration of the efforts made by these economies is found in a recent OECD report (*Going for Growth*), which places them at the top of the ranking for implementing structural reforms. Despite some encouraging signals, the so-called “light at the end of the tunnel” is not yet apparent to many people in these countries, particularly those who are paying the price of the adjustment with their jobs. But empirical evidence clearly shows that focus on reform pays off; not only in market access and credibility, but also in growth and jobs for the future.

A new model of governance

The credibility of this strategy is not only due to the fiscal consolidation process or the national reform agendas. It goes beyond the adjustment programmes and the need to respond to market pressure. It also results from a new model of economic governance, which was set up by European Union (EU) leaders to overcome past weaknesses.

There are four axes to this model: a new fiscal compact, the reinforced Stability and Growth Pact, a new Macroeconomic Imbalances Procedure and the “European Semester”.

At the European level, the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (EMU), which has been in force since January 2013, is one of the key elements. The Treaty, also known as the fiscal compact, provides for much enhanced coordination in fiscal and economic policy. This Treaty, together with a number of regulations, known as the Two-Pack, also strengthens the Stability and Growth Pact and enhances deeper fiscal coordination. Member States are required to make significant progress toward their so-called medium-term budgetary objectives for their budgetary balances. Furthermore — for the first time — a continuous and agreed reduction of the public debt ratio to 60% of GDP is required. Both the reduction of the deficit and total debt are subject to a new, graduated sanctions procedure, in which proposals from the European Commission can only be overturned by a large qualified majority of euro area countries.

This has been complemented by a new procedure for identifying and avoiding excessive macroeconomic imbalances. Where excessive imbalances exist, repeated failures to

follow recommendations by the Commission will result in sanctions. Although all Member States are analysed, the procedure is clearly focused on those with competitiveness problems and large current account imbalances.

Another major improvement is the introduction of the “European Semester”. In the first half of every year, the Member States’ budgetary and structural policies are reviewed by the Commission and the EU countries. This enables consistent policy guidance early enough for Member States to take recommendations into account when they adopt their national budgets for the following year. Through this measure, the euro area has reshaped its policy-making in a very substantial way in order to pre-empt the misalignments causing the crisis.

New support mechanisms

Collectively, Member States are putting national reforms in place and strengthening economic governance at the European level. This is really the core of the comprehensive strategy to overcome the crisis in a structural and lasting way. The establishment of financial crisis mechanisms — the EFSF and ESM — is complementary and can be regarded as the last line of defence in a situation when a Member State’s financing problems may put at risk the financial stability of the euro area as a whole or of its Member States. Moreover, they help sustain the confidence of investors and contribute to stabilising the markets. They buy time for euro area Member States to address the underlying issues.

The financial firewall has been strengthened as the crisis evolved. Initially Member States created a facility to help Greece, as an individual case. Later, governments set up a temporary crisis resolution mechanism, the EFSF, which committed an additional €43.7 billion to Ireland and Portugal, as well as a second assistance package to Greece totalling €144.6 billion. To provide the missing link in the setup of the EMU, this mechanism had to be made permanent. Therefore, the ESM was created, which added €500 billion in lending capacity. The ESM is financing the Cyprus programme (with a total commitment of up to €9 billion) and the Spanish bank recapitalisation programme (with €41.3 billion disbursed), yet still holds in reserve a robust firepower of nearly €450 billion.

The European Central Bank (ECB) has evidently played a crucial role in stabilising the markets with its other non-conventional measures, namely the Longer-Term Refinancing Operations (LTROs) and the announcement of Outright Monetary Transactions (OMTs). With the latter, the ECB may launch secondary market sovereign bond purchases when a Member State receives financial assistance under an ESM financial assistance programme entailing substantive reform conditionality and the possibility of primary market purchases.

The successful exits of Spain, Ireland and Portugal show that the model of crisis resolution is working. Financial assistance is linked to appropriate conditionality. This principle of EFSF/ESM lending has been and will continue to be independent of the instrument, such as loans, precautionary credit lines, bank recapitalisation, or intervention in the primary or secondary debt market. Conditionality may vary across instruments and cases depending on a country’s adjustment requirements. The key element, which is based on decades of IMF experience, is that successful financial assistance requires the correction of structural and fiscal deficiencies. When this is done, market confidence comes back and a successful return to the market or a full market financing at sustainable rates can be achieved, leading ultimately to an increase in growth and employment.

The continued existence of risk spreads does not question the success of the crisis resolution model and is to some extent desirable. Before the crisis, virtually no risk spreads existed among euro area countries. Investors now look more closely at sovereigns from a credit risk perspective. Fiscal deficits have been addressed and debt developments have become more favourable, but debt levels cannot be lowered in the short run. Sustained but low-interest rate spreads, reflecting the fiscal sustainability of countries, will therefore remain a feature of European fixed income markets. This is desirable as it imposes a market discipline on governments which was lacking before the crisis.

Strengthening the financial system

Both public and private sector efforts have made the financial system more resilient. Since the beginning of the crisis, policy-makers have taken a number of initiatives to strengthen regulation. They created new European supervisory authorities for different segments of financial markets, in particular for banks, insurance companies, and capital market instruments and rating agencies. Regulatory authorities also increased capital requirements for banks, as the European Banking Authority recommended a higher capital ratio of 9%. Ongoing efforts aim at improving the quality of capital. In parallel, between 2008 and 2011 governments in the euro area made €1.6 trillion available to back the banking system. Most of these amounts took the form of guarantees to back bank assets and liabilities. Others took the form of direct capital injections. EFSF and ESM programmes also contributed to the recapitalisation efforts by making nearly €100 billion available for that purpose to the governments of Cyprus, Greece, and Spain. The Commission estimates that between 2008 and the second half of 2013, overall bank capital increased by €450 billion, using both public and private sources, most of it being raised as private capital. The European Systemic Risk Board (ESRB) was created to monitor macro-prudential risks to

complement micro-supervisory functions. The ESRB will also have a role in gauging the macro-prudential instruments in the hands of supervisory authorities.

The situation of the banking system has improved but fragmentation could not be entirely overcome. Bank financing disintegrated across euro area countries for quite some time. Since 2012 the interbank market has again become more liquid and bank funding conditions normalised. Against that background, the decline in Target 2 balances and repayments of LTRO are indications of the need to rely on the support of the Eurosystem. But even with this fragmentation receding, bank credit developments and costs continue to differ substantially across countries. Credit conditions are more restrictive and costs are higher in peripheral countries.

With these problems in mind, policy-makers decided to create a banking union (Box 1). The key objectives of the banking union are, first, to put banking systems across Europe on the same footing and create confidence, and second, to break the vicious circle between banks and sovereigns. The first objective should be achieved through a set of common regulatory and resolution institutions — the Single Supervisory Mechanism (SSM) residing with

the ECB, the Single Resolution Board and the Single Resolution Fund. The second objective should be achieved through a paradigm shift of rescue measures. Instead of government bail-outs for financial institutions, private investors and shareholders should carry most costs of future bank restructuring or resolution through bail-in requirements. This will shield the public sector from demands in future crises.

Conclusion

Europe has implemented a far-reaching response to the crisis. Budget deficits are being reduced; competitiveness is being restored; current accounts are moving into surplus. Economic governance has been strengthened with the fiscal compact, a reformed Stability and Growth Pact, a new Macroeconomic Imbalances Procedure and the European Semester. A permanent crisis resolution mechanism is now fully in place. More needs to be done to fully complete the banking union, re-integrate financial markets and reduce unemployment levels, which are still unacceptably high. All this has the aim of creating a better-functioning and financially stable euro area, which will ultimately lead to more growth and employment.

Box 1. The ESM and the banking union

As part of its crisis response strategy, the EU has undertaken a set of measures in the financial sector that focus on better regulation, strengthened supervision and resolution frameworks, and financial backstops. The ultimate objective is to build a true banking union where financial institutions provide financial services across Europe. The Bank Recovery and Resolution Directive (BRRD) and the Capital Requirements Directive (CRD) introduce significant changes in the landscape for banking in Member States. The Single Supervisory Mechanism (SSM) will directly supervise the biggest 130 banks in the euro area while being ultimately responsible for all financial institutions of Member States concerned. The Single Resolution Mechanism will be able to take resolution action if needed, supported by a Single Resolution Fund financed by the industry.

The ESM has an important role in the banking union, as the organisation was created as a backstop for

euro area countries. Besides macroeconomic adjustment programmes and loans to Member States, the ESM also has the capacity to deal with financial sector issues. Currently the ESM can lend to an ESM Member for the purpose of recapitalising its banks, as was the case with Spain, or to provide financing to cover resolution costs.

Once adopted, the Direct Recapitalisation Instrument (DRI) will allow the ESM to invest directly in equity of ailing financial institutions, together with Member States and under strict conditionality. This possibility will mitigate the sovereign-bank nexus that has aggravated the sovereign debt crisis in Europe and should provide further reassurance to investors. Once adopted as a new ESM instrument by unanimous decision of the Board of Governors, the DRI could also be used — according to agreed procedures — to address capital shortfalls uncovered by the Balance Sheet Assessment exercise undertaken by the SSM.

Macroeconomic and financial environment

In 2013, the euro area economy progressed from stabilisation toward a modest recovery and financial market conditions normalised further. After several quarters of recession, the euro area started to grow again, though at a slow pace. This incipient growth has been driven mainly by a rise in exports outside the euro area and a gradual improvement in domestic demand, both of which are expected to gain momentum in 2014. Most peripheral programme countries continued to gradually stabilise or saw improvements in trade balances.

The stabilisation and incipient recovery of the euro area occurred against the background of strengthening growth in other developed economies, which temporarily proved challenging for emerging markets. In the euro area, structural reforms were progressing and fiscal performance improved. At the end of the year, Member States started to exit ESM and EFSF financial assistance programmes, and euro area growth showed positive momentum. From a financial markets perspective, developed market equities continued their strong rise on the back of monetary stimulus while short-term interest rates remained at very low levels. Peripheral euro area yields fell sharply as countries regained the confidence of investors and benefited from setbacks in emerging markets. The decline in volatility indices corroborated that risk premium was gradually decreasing, further confirming the turning point for risk sentiment in the euro area.

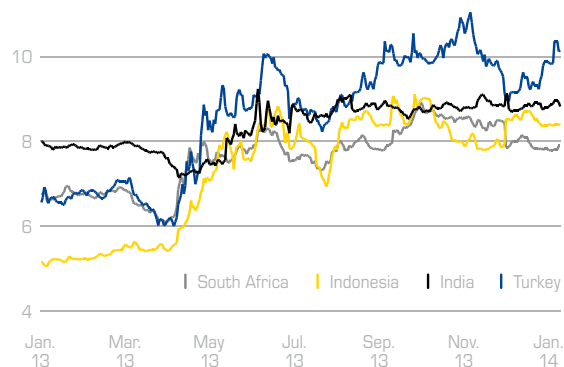
Global rebalancing

The stabilisation and incipient recovery of the euro area took place on the back of a rebalancing of the world economy. Growth prospects in developed economies improved while emerging market economies struggled. In the United States, growth decelerated in the short term due to necessary fiscal tightening but the growth outlook improved. Countries that had been lagging, such as the United Kingdom and Japan, exceeded estimates of economic growth. The recovery of developed economies was generally facilitated by the continued accommodative policy stance of monetary authorities.

At the same time, emerging markets struggled with higher rates of inflation, current account imbalances, high dependency on foreign capital and lower commodity prices. This and the expectation of future higher rates in the United States pressured a number of central banks into tightening monetary policy in the hope of combating capital outflow. The positive momentum in developed economies translated into a sustained period of currency weakness for emerging markets. In particular, countries

such as Brazil, India, Indonesia, South Africa and Turkey and were affected by the expectations of a reduced pace of Treasury purchases by the US Federal Reserve and a subsequently less accommodative environment (Chart 1).

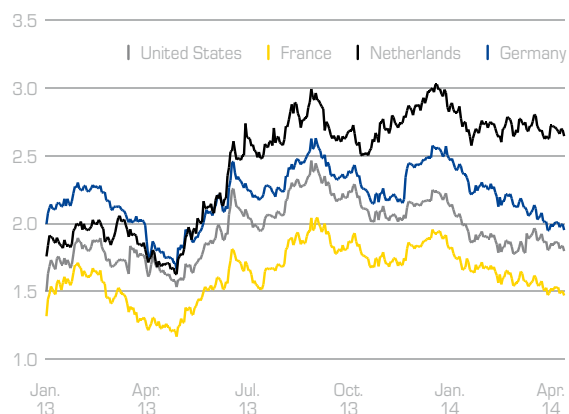
Chart 1. Emerging market 10-year sovereign bond yields jump during the second half of 2013 (in %)



Source: Bloomberg

As investors repatriated money from emerging markets, the euro area found itself one of the larger beneficiaries of capital inflows from the second half of 2013 onwards. The initial effect of the emerging market fallout was to further reduce European sovereign yields, especially those of peripheral economies. The same could not be said for traditional safe-haven assets, which were the first to react negatively to the reduced pace of US Federal Reserve asset purchases (Chart 2). Beyond the impact on yields, the emerging market turmoil could negatively influence the euro area's trade balance. However, euro area exports to emerging market economies, such as Brazil, China and Turkey, increased during the year and the real economic effect seemed to have been limited.

Chart 2. 10-year government bond yields in Germany, France, the Netherlands and United States (in %)



Source: Bloomberg



Juan Rojas

Deputy Head of Economic and Market Analysis

Joined the ESM in April 2013

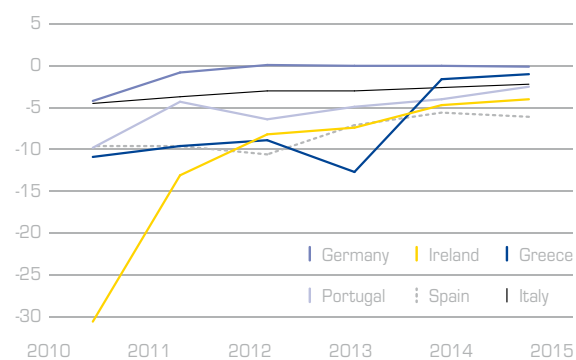
Worked in the Bank of Spain for nine years. Lecturer at the Universidad Carlos III (Madrid).

Working at the ESM provides a unique opportunity to contribute to the future of Europe. It is also an excellent example of what can be achieved by high quality team work, within a small organisation. The ESM project and design is not completed yet but it is well equipped to cope with the new challenges that lie ahead, and contribute to a more integrated Union.

Structural improvements in the euro area

During the year, the euro area economy made progress in several areas of adjustment and structural reforms; though much work is yet to be done, the actions certainly led to receding market concerns about the future of the euro area. Current account imbalances within the euro area were addressed, competitiveness improved and banking union plans gradually took form. Fiscal performance also recovered (Chart 3), with the euro area deficit estimated to decrease to 2.5% of GDP in 2014 from 3.1% in 2013, while debt-to-GDP is expected to peak at 96% in 2014.

Chart 3. Fiscal balance and 2013-15 forecast, euro area Member States (as % of GDP)



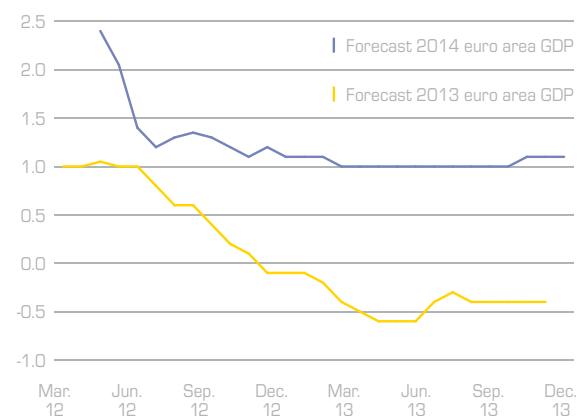
Source: Eurostat and EC, Spring forecast 2014

Specifically, Member States that went through EFSF/ESM financial assistance programmes have made necessary fiscal adjustments and are now expected to experience

modest economic growth. Ireland and Spain successfully exited their assistance programmes, and recently Portugal reached a similar positive outcome. Cyprus, which has seen a protracted recession that has had grave socioeconomic impact on the country, is expected to move gradually out of recession in 2014 and record growth in 2015 (see Programme country experiences below). However, Cyprus still has some distance to run until it reaches this pivotal moment, demonstrating the importance of the EFSF and ESM as the common crisis resolution mechanisms for the euro area. The stringent conditionality of the programmes and the continuous monitoring of adherence to the targets and deadlines have ultimately strengthened beneficiary Member States.

Though euro area GDP on average declined by 0.5% over the year, signs of positive development have been evident. The trend in GDP growth was increasingly positive as the year progressed (Chart 4). Consumer and investment spending picked up during the second half of 2013, though the distribution of spending across euro area Member States remained uneven. Euro area HICP inflation is expected to rise to 1.2% in 2015, reflecting modest cost pressures as domestic demand recovers. The level of inflation below the ECB's objective of price stability should also be seen against the background of required price adjustments in peripheral countries. After a persistent rise, unemployment is expected to remain fairly stable in 2014 at a rate just below 12%, again with significant differences between countries.

Chart 4. Evolution of euro area GDP growth expectations (in %)



Source: Bloomberg

Public debt in almost all euro area countries continued to rise. The banking sector had not yet recovered to a level where government support could be removed and household borrowing rates still showed substantial disparities between countries. Notwithstanding these adverse elements, the euro area as a whole, illustrated by countries such as Spain, made substantial progress in addressing structural imbalances.

Financial market conditions

Developed market equities maintained the positive trend that has prevailed on the back of monetary stimulus. The S&P 500 equity index recorded its best performance in over 15 years, giving investors a 30% return (Chart 5). The emerging market fallout further benefited euro area equity performance as funds were redeployed in peripheral equities that presented relatively reduced risks to investors.

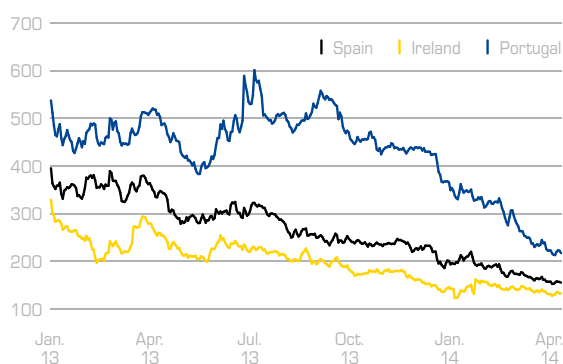
Chart 5. Stock prices in the euro area (rhs) and United States (lhs) (in index value)



Source: Bloomberg

Short-term interest rates remained at very low levels across all major developed economies, amid the low policy rate environment and forward guidance indicating that lower rates were to be maintained for some time. Longer-maturity Treasuries and Bunds experienced bouts of volatility as expectations of tapering set in during the summer months. In Europe, the ECB cut the main refinancing rate twice, in addition to extending the longer-term refinancing operations well into 2015 and introducing forward guidance as a new tool to steer short-term rates. European peripheral bonds experienced more favourable financing rates, illustrated by Greece tightening by more than 400 bps to the German curve, and Ireland and Spain tightening by more than 150 bps (Chart 6).

Chart 6. Spain, Ireland and Portugal 10-year bond spreads vs Germany (in basis points)



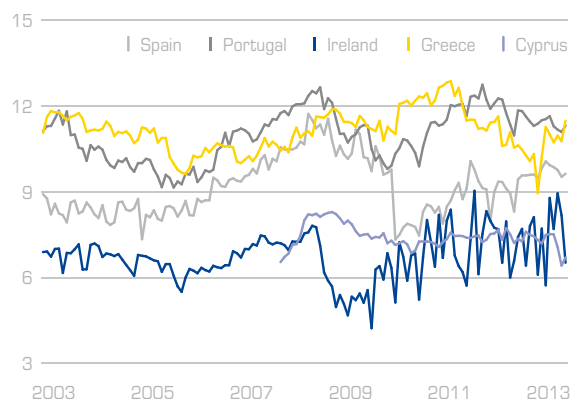
Source: DataStream and ESM calculations

These positive market developments clearly indicate that confidence is returning to euro area markets, a trend also confirmed by a decrease in risk premium observed in volatility indices.

Risks to the outlook

2013 was a year where the euro area progressed from stabilisation toward modest recovery. The issues that the euro area will need to overcome will not be new. Inflation remains very low, unemployment is only expected to fall moderately in 2014, and both public and private debt remain high. Despite some progress, disparities between domestic economies remain in areas of unemployment as well as financing conditions for households and SMEs (Chart 7). It is therefore evident that the biggest tasks at hand are restoring proper functioning of the monetary transmission mechanism, and defragmenting the national economies and financial sectors in the euro area. This essentially means that policy-makers must continue to make the euro area a more efficient, competitive and stable market-place. The ECB in its new capacity of single supervisor should also encourage confidence to return to the financial sector.

Chart 7. Composite household borrowing cost in the euro area across all maturities (in %)



Source: ECB

National policy-makers are urged by the European Commission to implement country-specific recommendations, which should enable Member States to boost domestic growth potential and job creation, further reduce deficits and debt, and push through social reforms. In this context the Excessive Deficit Procedure and Excessive Imbalance Procedure should give further incentives for appropriate actions to be taken.

Programme country experiences



► Cyprus

The programme's objectives are to restore financial sector stability, strengthen public finance sustainability, and implement structural reforms in order to support sustainable and long-run growth. Under the Financial Assistance Facility Agreement signed between the ESM and Cyprus, an amount of up to €9 billion is available to the country in order to finance debt redemption, fiscal deficits and the recapitalisation of the financial sector. In addition, the IMF contributes up to €1 billion to cover the country's financing gap. From May 2013 until March 2014, a total of €4.6 billion was provided to Cyprus by the ESM, after ensuring compliance with prior actions and programme conditionality defined in the Memorandum of Understanding.

In the financial sector, the main policy measure adopted in 2013 included the bail-in of uninsured depositors and the imposition of restrictive measures in the economy, in order to safeguard financial stability in the domestic economy. Fiscal consolidation focused on reducing expenditure growth on the public sector wage bill and social benefits, while the authorities successfully implemented some important revenue side measures (for example, an increase in immovable property taxes). Regarding structural reforms, important steps have been taken on revenue administration, reforming the social welfare system and preparing for privatisations.

The recession in 2013 was severe (-5.4%), but less steep than expected at the beginning of the programme. The better than expected macroeconomic performance is attributable to the dynamics of private consumption and the contributions of tourism and professional business services. Overall, consumption fell by 5.6%, while investment

declined sharply by 21.6%. The external sector contributed positively to GDP trends, with imports declining more (-14.1%) than exports (-4.2%).

Fiscal developments were better than expected in 2013, with the government reaching the deficit targets by a considerable margin. The overall deficit is expected to be 5.5% of GDP, while the primary deficit is seen at 1.8% of GDP. The fiscal outturn is attributed to better than expected macroeconomic developments, as well as to the expenditure constraint, which more than offset the slight underperformance in revenues.

The banking system is burdened by very high level of Non-Performing Loans (NPL). Despite the significant restructuring that has taken place in the banking sector, the level of problematic loans is very high (NPL ratio at 47.6% as of February 2014) compared with other programme countries. Effective management of NPLs is critical to restore banks' ability to finance domestic economy.

Overall, despite the robust programme implementation, risks remain to the stabilisation of the economy. The greatest challenge lies with the health of the financial sector; key policy issues are NPL management, private sector debt restructuring and ensuring that banks' restructuring plans are fully implemented. Success in bank restructuring will contribute to depositor confidence and pave the way to lifting the restrictive measures in accordance with the agreed roadmap. On the upside, progress in negotiations on the Cyprus reunification issue would have a profound impact on the programme.



Greece

The objectives of the economic adjustment programme for Greece are to restore sustainability of public finances, restructure and stabilise the financial system, and support long-term growth by implementing an ambitious agenda of structural reforms. From March 2012 to March 2014, a total of €99 billion was disbursed from the €109.1 billion Master Financial Assistance Facility Agreement between the EFSF and Greece, after ensuring compliance with prior actions and other policy conditionality defined in the Memorandum of Understanding. Policy measures adopted in 2013 included improvements in tax administration and public administration more generally, liberalisation of regulated professions, labour market reforms and rationalisation of public expenditures. In the financial sector, the second phase of the recapitalisation of the banking system was completed by June 2013.

The macroeconomic outlook improved in 2013. The recession slowed to a pace of -3.9% in 2013, compared with -7% the previous year. The contraction was led by a 12.8% drop in investment and a 6% fall in private consumption. The external sector continued to contribute positively to growth, with exports rising 1.8% and imports declining 5.3% on an annual basis. Data indicate that the economy is slowly turning around, clearly supported by a good tourism season, the government's efforts to restructure the economy, and the improvement of the global environment.

Fiscal developments suggest that in 2013 Greece reached a headline general government deficit of 2.1% of GDP (excluding the impact of support to financial institutions) and over-performed its primary balance target. The primary surplus reached €1.5bn, or 0.8% of GDP as per the adjustment programme definition, better than the target of a primary balance. This performance is attributed both to lower expenditure and higher revenue.

The external adjustment is also proceeding fast, with Greece registering its first ever current account surplus in 2013 (in Balance of Payments terms), at 0.7% of GDP. The improvement reflects primarily a 12% decline in the trade deficit. Strong receipts from tourism helped trigger an 11% increase in the service surplus. As a reward for the adjustment, foreign investors showed a renewed interest in the economy.

Behind these positive trends stands a significant improvement in the competitiveness of the economy. Ambitious labour market reforms leading to real wage cuts have started to yield results, with Greece more than recovering the cumulative loss in labour cost competitiveness recorded between 2000 and 2009. Implementation of a wide range of growth-enhancing structural reforms has also contributed to improving structural competitiveness. Since 2011, Greece has gained 29 positions in the overall ranking in the World Bank's Ease of Doing Business index, and the country has been leading the OECD's *Going for Growth* report.

The country now stands in a much-improved position compared with 2010, when it lost market access. The progress achieved in fiscal performance and competitiveness has translated into the elimination of the twin deficits in the primary fiscal balance and the current account. Secondary bond market performance as well as a first highly successful bond issuance in early 2014 show that market participants have acknowledged the adjustment made so far. Policy-makers should now focus on further improving programme implementation, safeguarding the pace of reforms and keep sufficient fiscal discipline to entrench the prospect for a rebound of the economy.



▶ Ireland

Ireland was able to regain market access gradually in 2013 and to conclude its EU/IMF financial assistance programmes at the end of the year. The Irish financial assistance programme started in November 2010, and Ireland received €17.7 billion from the EFSF along with close to €50 billion from the EFSM, the IMF and bilateral loans. The main thrust of the economic adjustment linked to programme conditionality was to restructure the Irish financial sector, to assure the sustainability of the public finances. During 2013, Ireland undertook reforms mainly in its public sector and to increase the competitiveness of its economy. Thereby it also strengthened the basis for a return to growth, duly pursuing its fiscal and financial adjustment paths and continuing to implement a range of structural reforms.

GDP continued to expand during 2013 once one-off factors from the pharmaceutical industry are excluded. In 2013, real GDP declined by 0.3% due to the impact of the “patent cliff” in the pharmaceutical industry but this was mostly due to the recent revision of figures by the Central Statistics Office (CSO) for the fourth quarter. The labour market has been improving and the unemployment rate declined to 11.7% in April 2014, down from a peak of over 15% in early 2012, according to the CSO. Also on a positive note, the housing market started to recover during the course of the year.

The fiscal and current accounts also continued to improve. The general government deficit declined to 7.1% of GDP in 2013 after reaching 8.1% in 2012, although it still remains high. As a consequence, government debt remains high and increased during 2013. It rose to 124% of GDP at the end of the year, from 117.4% of GDP in 2012. Thanks to competitiveness gains, the Irish current account surplus increased to close to 6.6% of GDP in 2013, one of the highest in the euro area.

By the start of 2014, market access had been fully restored. Ireland was the first country under an EFSF financial assistance programme to fully return to the market. It was able to issue regularly in syndicated deals and started an auction schedule in the first quarter of 2014. Irish sovereign bond yields have declined substantially since late 2011, with the 10-year yield down to around 3% at the end of 2013 – the lowest yields in the euro area peripheral programme countries.

Despite these positive developments and the successful exit from official financial assistance, the Irish authorities need to maintain the reform momentum. As the government deficit and debt remain high, Ireland requires a fiscal policy consistent with fiscal targets set in the Stability and Growth Pact. Structural reforms shall boost competitiveness and support the solid growth rates necessary for public debt adjustment. On the financial sector side, Irish banks are set to continue implementing their restructuring plans.



▶ Portugal

During 2013, Portugal followed the positive adjustment path that started in 2011 and successfully concluded the programme in May 2014. Following the last disbursement in April, the EFSF financial assistance programme made €26 billion available to Portugal. Since the beginning of the programme, Portugal has significantly corrected its macroeconomic imbalances (both external and fiscal) and implemented a wide range of structural reforms. More specifically, during 2013, Portugal continued to implement changes in the fiscal framework, labour and product market that had started in the previous years.

GDP contracted by 1.4% in 2013, somewhat less than initially expected. This was mostly due to weak domestic demand, which contracted by 2.6%. Exports continued to increase, by 6.1% in 2013, thanks to continuing gains in competitiveness. Economic activity finished the year with a strong momentum, with three consecutive quarters of expansion. The current account balance improved and registered a small surplus in 2013 of 0.4% of GDP, versus the 2% deficit recorded in 2012. The unemployment rate has also started to fall, down 2.3 percentage points from its peak, to 15.3%.

Despite negative rulings from the constitutional court that cancelled some of the planned spending cuts, the fiscal deficit declined to 4.9% of GDP (5.3% excluding one-off factors), or 4.5% of GDP excluding Banif recapitalisation from 6.5% in 2012, below the agreed Excessive Deficit Procedure target of 5.5% of GDP. Yet, as a result of the persisting government deficit and the weaker economic activity, government debt rose to close to 130% of GDP at the end of 2013, up from 124.1% in 2012.

During the year, financial market perceptions and market access continued to improve. Portugal finished its financial assistance program in May without requesting further official support. It was able to return to market financing at long maturities, through syndicated deals of 5- and 10-year bonds. Following these encouraging developments during 2013 and the conclusion of the programme, it is important that Portugal continues to implement the agreed structural reforms and fiscal adjustment to improve economic growth and reduce government debt.



Spain

Spain concluded its financial assistance programme with the ESM on 31 December 2013. The ESM's Financial Institution Recapitalisation Facility proved instrumental in recapitalising and restructuring Spain's troubled banks and putting them on a sound footing. The facility, which was made available in July 2012, amounted to €100 billion, signalling the determination of the Spanish authorities and the euro area governments to thoroughly address any outstanding banking problem.

The policy measures taken by the Spanish authorities in the context of the programme addressed the capital requirements of the banks, set up a framework to handle non-performing assets, and substantially improved supervision and regulation. After the first disbursement of ESM notes (€39.5 billion) transferred on 11 December 2012 to the FROB (the Spanish fund for orderly bank restructuring), the Spanish government formally requested on 28 January 2013 the disbursement of €1.86 billion for the recapitalisation of Group 2 banks. The funds were transferred to the FROB in the form of ESM notes on 5 February 2013. Overall, the outlook for the Spanish banking sector, and for the economy in general, has improved substantially. After posting significant losses in 2012, banks returned to profitability in 2013 and the capital position of recapitalised banks is now comfortable, with Core Tier 1 ratios above 10%.

Latest macroeconomic developments suggest the economic recovery is under way. Growth has returned, with quarterly GDP growth rates turning positive in the second half of 2013, up 0.2% in the fourth quarter relative to the third. Domestic demand provided less of a drag on

economic activity during 2013, with an annual contribution to growth of -2.7% (compared with -4% in 2012). The contribution of external demand to growth was more moderated (1.5%) relative to 2012 (2.4%). Still, exports continued to increase in the last quarter of the year, although imports have also started to recover.

The correction of imbalances has continued, despite some slippages observed on the fiscal side. The overall fiscal deficit of the general government stood at 6.6% of GDP, on the back of lower-than-expected revenue collections, above the 6.5% deficit target. The economy was supported by further gains in competitiveness, resulting in a 0.8% of GDP current account surplus in 2013, the first in many years.

Growing investor confidence resulted in a solid bond market performance. This provided a welcome reward to the gradual improvement of the real economy. Sovereign bond yields reached new lows across maturities compared with the crisis period, and the rise in share prices reflected the positive sentiment surrounding the economic recovery.

Spain has now entered a Post-Programme Monitoring phase. The ESM will continue to implement its Early Warning System in cooperation with the European Commission to monitor Spain's ability to honour the repayments to the ESM. Further economic improvement and the continuation of structural reforms shall entrench the prospects for sustainable growth into the medium term.

Box 2. Potential savings on EFSF/ESM interest payments

EFSF and ESM financial assistance is granted to Member States that cannot access capital markets at affordable rates and pose a threat to the financial stability for the euro area as a whole or its Member States. The EFSF/ESM disbursed financial support to beneficiary Member States at much lower interest rates than those that would theoretically have been offered by the market. This initially generates substantial resource savings, helping to provide the assistance needed to implement fiscal and structural reforms to foster growth in the medium term, and thereby ultimately supporting market access and debt sustainability.

The EFSF/ESM provided loans to Cyprus, Greece, Ireland, Portugal and Spain. The simplest way to estimate the savings achieved in 2013 is to compare the effective interest rate payments on EFSF/ESM loans with the interest rate that these countries would have paid had they been able to cover their financing needs in the market in the absence of disruption. In the calculation, we use the average theoretical market spread of the 5- and 7-year bond of each country matching the EFSF/ESM maturity profile on the three months before and after each country requested support, and compare this with the equivalent EFSF/ESM funding cost.

The results have nonetheless to be read with some caution, since market rates for these countries were not available throughout 2013 in the amounts being considered and so do not reflect the true financing costs. Moreover, countries requested support in different contexts of the euro area sovereign debt crisis, when different EU support mechanisms were available, which may

also account for the cross-country differences observed in our estimates.

In addition, these rates neither take into account the conditionality that applies to EFSF/ESM loans and the related reduction in spreads in the course of the programme, nor provide a quantification of the current situation, with some countries such as Spain reporting record low market rates. Future funding costs, as well as potential savings for beneficiary ESM Members, will depend on their precise funding structure and general sentiment in the markets. Therefore, these future funding costs cannot be extrapolated from this finding.

Looking at past performance, the table below shows the results in terms of amounts saved and as percentages of GDP in 2013. The savings are significant, ranging from 0.2% of GDP in Spain to 4.7% of GDP in Greece in 2013. At the peak of the crisis, these were even larger: towards the end of 2013, countries such as Ireland and Spain (and to a lesser extent Portugal) were already approaching the conclusion of their programmes and were benefiting from lower spreads due to the effective crisis response and good programme implementation.

For illustrative purposes, the savings are also represented as a percentage share of total primary expenditures. This captures more closely the idea of fiscal space attributable to these savings. The budgetary space is again particularly notable for Greece amounting to almost 9% of total primary expenditures, which in this case effectively accounts for more than the total amount of public resources spent on education.

Table 1. Potential savings of EFSF/ESM financing vs theoretical market cost in 2013

	Level in € billion	As share of GDP	As share of total primary expenditures
Cyprus	0.24	1.5	3.4
Greece	8.58	4.7	8.6
Ireland	0.68	0.4	1.1
Spain	2.43	0.2	0.6
Portugal	1.27	0.8	1.7

Source: Bloomberg, European Commission. Figures are based on ESM staff calculations



Nicola Giammarioli

Head of Strategy and Institutional Relations

Joined the EFSF in August 2012

Worked at the IMF Executive Board as Senior Advisor/Alternate Executive Director. Previously was an advisor of the Italian Minister of Economy and Finance; Economist and Senior Economist at ECB from 2001-07.

On my way back from Washington to Rome I stopped by Luxembourg, where a bunch of pioneers were working day and night – including weekends – to forge a brand new institution. It is a pleasure to work with very motivated colleagues with different backgrounds, pursuing the objectives of creating better conditions for Europe and its citizens.

Box 3. The ESM/EFSF's Early Warning System

The objective of the Early Warning System (EWS) is to determine the ability of an ESM Member to repay its obligations. According to the ESM Treaty, "The ESM shall establish an appropriate warning system to ensure that it receives any repayments due by the ESM Member under the stability support in a timely manner". This requires an assessment of the short-term liquidity position of the sovereign, its market access, and the medium- to long-term sustainability of its public debt. It may also require an assessment of banking developments whenever relevant to assess repayment flows. The work takes into account and complements the fiscal and debt sustainability analysis undertaken by the European Commission (EC) and the European Central Bank (ECB) during the programme and post-programme period.

The ESM's Internal Risk Committee (IRC) assesses the risks to the planned repayment schedule in the context of likely scenarios. In light of this assessment, judgement by the ESM's management and governing bodies is required to identify any potential deterioration in the credit risk of the institutions and any adjustment to the loan value. No value adjustment has been required as of 31 December 2013, and thus none has been recognised.

The process is organised as follows:

- The ESM's Asset and Liability Management (ALM) department provides a monthly payment overview for the next year for each beneficiary ESM Member.
- Five months before each payment date, the beneficiary ESM Member provides the ESM with a

cash flow overview for the period up to the payment date and a schedule of the aggregate monthly cash inflows and outflows including the ESM payment.

- The ESM deepens its analysis of the liquidity risk if the repayment due exceeds a risk threshold. This involves examining market access and the conditions this depends on, in particular the public debt sustainability of the country and its budgetary developments based on the work by the EC in liaison with the ECB. This entails close liaison with the EC and ECB to incorporate their analysis. The results are discussed with national authorities, if necessary to collect further insight into the economic and financial situation of the ESM Member concerned.
- The report provided to the IRC includes an assessment of the likelihood of payment. Based on the assessment, the IRC forms a view on the financial situation of the borrower and likelihood of payment of the amount due in three months. Should a clear repayment risk be identified, the ESM Managing Director consults the IRC, the Board of Directors and the Eurogroup Working Group.

EFSF guarantors agreed at the Eurogroup meeting held on 9 December 2013 that the ESM warning system procedure should also be applied to the EFSF. The EWS exercise will take place until the totality of ESM and EFSF loans are repaid by beneficiary members. In the meantime, close coordination of work and country missions with the EC and ECB is ensured, in programme and post-programme review work.

ESM Activities

Lending activities

Cyprus

The ESM signed the Financial Assistance Facility Agreement with Cyprus on 8 May 2013, which included a Loan Facility for a total amount of up to €10 billion, including a contribution from the IMF. This was eventually fixed at €8.968 billion, after the IMF decided to grant financial assistance to Cyprus of SDR 891 million. The loans to Cyprus will have a maximum maturity of 20 years and a maximum average maturity of 15 years (14.86 years WAM at the end of 2013).

Two disbursements were made under the first tranche of the Cypriot facility: the first on 13 May 2013 for a total of €2.0 billion; the second on 26 June 2013 for €1.0 billion. Under the second tranche of the Cypriot facility, on 27 September 2013 a total of €1.5 billion was transferred through the delivery of ESM notes to use for recapitalisation of the Cooperative Central Bank (Table 3). The third tranche of €100 million was disbursed on 19 December 2013 (Table 2). No interest payment dates occurred in 2013.

Table 2. Funds disbursed to Cyprus in 2013

Tranche	Disbursement	Value date	Maturity	Loan amount (€ million)	Type
Tranche 1	Disbursement 1	13/05/2013	13/05/2026	1,000	
		13/05/2013	13/05/2027	1,000	
	Disbursement 2	26/06/2013	26/06/2028	1,000	
Tranche 2	Disbursement 1	27/09/2013	27/09/2029	750	Bank Recap
		27/09/2013	27/09/2030	750	Bank Recap
Tranche 3	Disbursement 1	19/12/2013	19/12/2019	100	
Tranche 3	Disbursement 1	19/12/2013	19/12/2019	100	

Table 3. ESM bonds that fund the Cypriot Bank Recapitalisation (tranche 2)

ISIN code	Maturity	Rate	Amount issued (€ million)
EU000A1U98Y4	27/03/2015	Floating Rate 6m Euribor-21bp	1,500

Spain

The Financial Assistance Facility Agreement provided to Spain, signed on 29 November 2012, included a Financial Institution Recapitalisation Facility for a total amount of €100 billion, with a maximum maturity of 15 years and a maximum average maturity of 12.5 years (12.49 years WAM at the end of 2013). The first disbursement under the first tranche took place in December 2012, with an amount of €39.468 billion through the delivery of ESM notes (Table 4). Once the initial funding instrument matures, these notes will be rolled over to the ESM diversified funding pool.

Table 4. ESM bonds that fund the Spanish Bank Recapitalisation (tranche 1 and 2)

ISIN code	Maturity	Rate	Amount issued (€ million)
EU000A1U97C2	11/02/2013	Zero Coupon Discount bill	2,500
EU000A1U97D0	11/10/2013	Zero Coupon Discount bill	6,468
EU000A1U98U2	11/06/2014	Floating Rate 6m Euribor-12 bp	6,500
EU000A1U98V0	11/12/2014	Floating Rate 6m Euribor-12 bp	12,000
EU000A1U98W8	11/12/2015	Floating Rate 6m Euribor-6 bp	12,000
EU000A1U98X6	05/08/2015	Floating Rate 6m Euribor-15 bp	1,865

The bonds were provided to the Bank of Spain, which received them on behalf of the Kingdom of Spain, and subsequently transferred to the FROB, which in turn used them to recapitalise the four financial institutions it had taken over (Group 1 banks) as well as SAREB (the Spanish asset management company). The loan amortises in equal amounts between 2022 and 2027 (Tables 5 and 6).

Table 5. Funds requested by Spain for Group 1 banks

Tranche	Disbursement	Value date	Maturity	Loan amount (€ million)	Type
Tranche 1	Disbursement 1	11/12/2012	11/12/2022	6,578	Bank Recap
		11/12/2012	11/12/2023	6,578	Bank Recap
		11/12/2012	11/12/2024	6,578	Bank Recap
		11/12/2012	11/12/2025	6,578	Bank Recap
		11/12/2012	11/12/2026	6,578	Bank Recap
		11/12/2012	11/12/2027	6,578	Bank Recap
Tranche 3	Disbursement 1	19/12/2013	19/12/2019	100	

Table 6. Split of the funds requested by Spain for Group 1 banks and SAREB

Institution	Amount (€ million)
BFA-Bankia	17,959
Catalunya Caixa	9,084
NCG Banco	5,425
Banco de Valencia	4,500
SAREB	2,500

The second disbursement under the Spanish facility was made on 5 February 2013 for a total amount of €1.865 billion, again through the delivery of ESM bonds, following 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 7 and 8). The capital injection was made by the FROB in both Group 1 and Group 2 banks.

Table 7. Funds requested by Spain for Group 2 banks

Tranche	Disbursement	Value date	Maturity	Loan amount (€ million)	Type
Tranche 2	Disbursement 1	05/02/2013	11/12/2024	932.5	Bank Recap
	Disbursement 1	05/02/2013	11/12/2025	932.5	Bank Recap

Table 8. Split of the funds requested by Spain for Group 2 banks

Institution	Amount (€million)
Banco Mare Nostrum	730
Banco Ceiss	604
Caja 3	407
Liberbank	124

During 2013, the ESM received interest payments (including the margin) from Spain totalling €207,555.822. At the end of 2013, the availability period of the Spanish facility came to a close, and at this point the undrawn amount of €58.67 billion under the facility was automatically cancelled.



Gong Cheng

Policy Strategy Officer

Joined the ESM in January 2014

Worked as an economist in the International Macroeconomics Division at the Banque de France.

For a Chinese who is interested in European affairs, joining the ESM represents a unique opportunity to work on the most pressing issues related to the European debt crisis. The frequent interaction with open-minded colleagues coming from all around the world is both fascinating and enriching.

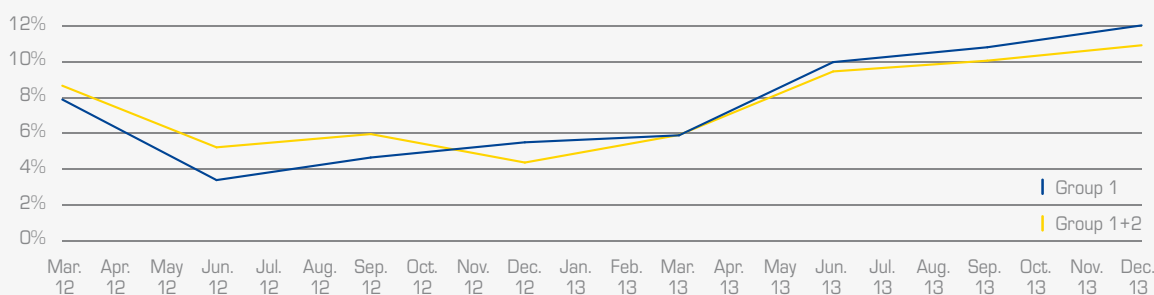
Box 4. Restructuring of the Spanish banking sector

With the inception of the crisis in 2008, the real estate bubble burst and impaired loans in the Spanish banking sector soared. After several attempts by the government to restructure the banking sector through recapitalisations of banks and a rationalisation of the sector through mergers of weak and strong saving banks (cajas), the sector went into deep distress with some institutions reporting significant deposit outflows. On 25 June 2012, the Spanish government made an official request to the Eurogroup for financial assistance for its banking sector.

transferred problematic assets (mainly loans to real estate developers and foreclosed real estate assets) to SAREB, the asset management company/bad bank.¹

The recapitalisation of the banks was undertaken by the FROB in the first quarter of 2013. The FROB took the majority control of four banks via equity shares, and recapitalised the remaining banks by investing in additional tier 1 convertible contingent bonds. In parallel, the banks undertook subordinated liabilities exercises

Chart 8. Common Equity Tier 1 of Spanish banks under programme



The financial assistance aimed to support the Spanish government in restructuring the domestic banking sector in order to cover capital shortfalls identified in a number of banks. An initial top-down assessment exercise, released in June 2012, indicated that the additional capital needs of the Spanish banking sector as a whole could be estimated in a range of €51–62 billion. In July 2012, the Eurogroup approved an envelope of financial assistance for Spain of up to €100 billion (including a safety margin on the initial estimation) and the Spanish authorities signed a Memorandum of Understanding. The assistance was initially provided under an EFSF programme; on 28 November 2012, the ESM Board of Governors decided that such a financial assistance programme would be assumed by the ESM.

The support to the Spanish banking sector was based on three pillars. First, an asset quality review and a bottom-up stress test on the 17 largest Spanish banks identified individual capital needs. The stress tests identified in the adverse scenario capital shortfalls of €55.9 billion in ten banks. Two banks were able to cover a €3.4 billion capital gap using capital management measures, mainly through disposal of assets (€900 million), and raising fresh capital (€2.5 billion). Second, eight banks with estimated capital needs of €52.5 billion were requested to present capital and restructuring plans to address the shortfalls and to obtain public resources in line with state aid rules. Third, banks receiving public support segregated and

(SLEs)² that generated €13.6 billion of new capital. This reduced the total capital needs to €38.9 billion from the initial €52.5 billion.

The ESM's financial assistance for Spain was accompanied by "horizontal conditionality" intended to strengthen the banking sector as a whole. This included regulatory capital targets, bank governance rules (including an in-depth reform of the savings banks), an upgrade of reporting requirements and improved supervisory procedures.

The ESM financial assistance programme for Spain expired on 31 December 2013 on a very positive note. Not only did the banks return to profitability and the capital position of recapitalised banks become comfortable, but also the overall economic recovery is clearly under way. However, Spain will need to continue with structural reforms to avoid the return of imbalances and ensure sustainable growth.

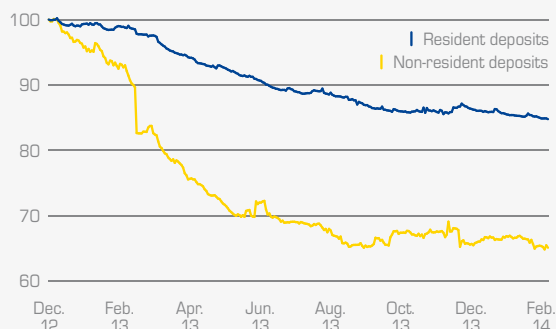
1 The Spanish government, through the Fondo de Restructuración Ordenada Bancaria (FROB) provided SAREB with €2.5 billion in the form of equity capital and subordinated debt. After this capital injection, the FROB held 45% of SAREB, while the remaining 55% was held by private shareholders (mainly domestic banks and insurers).

2 The SLE regime was introduced in the Spanish legislation on 31 August 2012 with the Royal Decree-law 24/2012, which was then transformed into the law 9/2012. The new SLE regime introduced the obligation for subordinated bondholders to bear the losses arising from restructuring and resolution of banks after the shareholders.

Box 5. Addressing the challenges of the financial sector in Cyprus

In 2012, Cyprus was going through an unprecedented banking crisis - its banking sector amounted to about 800% of GDP (Box chart 10). The reasons for the vulnerabilities in the banking system were twofold. First, Cypriot banks had very large exposures to Greece, which resulted in losses of about €4 billion, or about 25% of the country's GDP, following the Greek private sector involvement (PSI) operation. Second, the banking sector's domestic problems were fuelled by weak credit standards, unwinding of the housing boom and the economic downturn, which all together led to sizeable credit losses. According to the stress-test carried out by the Central Bank of Cyprus during the second half of 2012, Cypriot banks had an estimated capital shortfall of €10 billion (about 60% of GDP).

Chart 9. Total deposits, excluding bailed-in amounts (100=1 Jan 2013; last data 18 March 2014)



Source: Central Bank of Cyprus

Some €8 billion of these losses were faced by the two largest Cypriot banks — Bank of Cyprus (BoC) and Cyprus Popular Bank (CPB) — which represented about 50% of the domestic banking sector and held assets approximating 400% of the country's GDP. The problems in these two banks had to be solved expeditiously, given the large capital shortfalls and a loss of confidence in the overall financial system, evident from massive deposit outflows in the first quarter of 2013 (Box Chart 9).

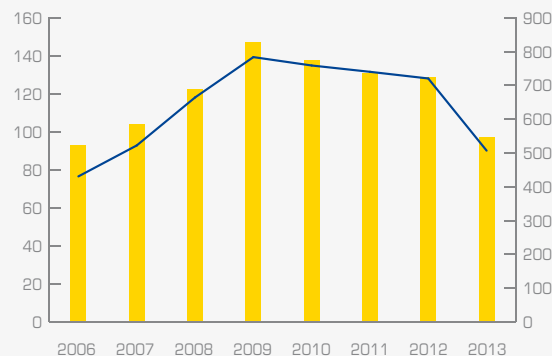
In March 2013, a decision was taken to resolve CPB and to restructure BoC. Given the large capital needs and the government's limited financial capacity, these banks had to be recapitalised with means other than public money. As a result, bank creditors — junior and senior bond-holders and uninsured depositors — were bailed-in.

The Greek operations of BoC and CPB, and also of Hellenic Bank, were sold to a Greek lender (Piraeus Bank) and the recapitalisation of BoC and CPB took place through bailing-in of senior creditors (mainly uninsured

depositors). CPB was split into a going concern entity and a liquidation vehicle, with about €4 billion of uninsured depositors fully bailed-in. The going concern entity was taken over by BoC, which was simultaneously recapitalised through a senior creditors' bail-in. As a result of these actions, the size of the Cypriot banking sector decreased by about 150% of GDP.

The cooperative credit sector, with total assets close to €17 billion, had an estimated capital shortfall of €1.5 billion. The sector was recapitalised through the use of programme funds after the approval of the restructuring plan (which involves a significant consolidation in the sector and strengthening of its supervision). Hellenic Bank, the country's third-largest bank, which had a capital shortfall of slightly over €300 million, was capitalised through private sources³ in November 2013.

Chart 10. Total Assets of the Banking sector/GDP (% to GDP; total assets in €bn)



Source: Central Bank of Cyprus

The recapitalisation of the two largest banks in Cyprus was unique and required exceptional solutions (such as a bail-in of uninsured depositors). To mitigate further risks to financial stability (deposit outflows), the authorities decided to introduce temporary restrictions on the free movement of capital. These restrictions will be lifted gradually, according to the roadmap agreed between the authorities and the programme partners in August 2013. The principal challenge for the Cypriot banking system is the management of non-performing loans, which currently stand around €30 billion (close to 200% of GDP). Resolution of such a large issue will take time and has to target both the debtor (insolvency regime) and the creditor (robust NPL management procedures and sufficiency of capital).

³ Hellenic Bank increased its capital by €103 million and issued two CoCos in amounts of €126 million and €128 million, achieving a core T1 ratio of 9.5%.

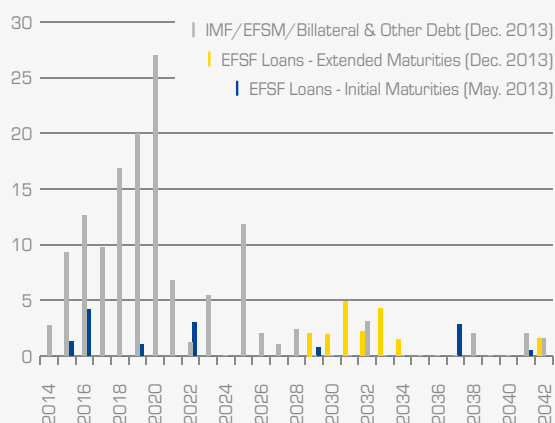
Box 6. EFSF extension of maturities for Ireland and Portugal

On 12 April 2013, the Eurogroup agreed, subject to successful programme implementation, to lengthen the average maturity of EFSF loans granted to Ireland and Portugal by up to 7 years. The agreement aimed to support these countries' efforts to regain full access to market financing and successfully exit their programmes by smoothing their debt redemption profiles, lowering their refinancing needs in the period subsequent to their economic adjustment programmes, and improving the countries' debt sustainability.

Ireland

The extension of EFSF and EFSM loan maturities aimed to improve the Irish redemption profile during the amortisation hump of 2014-25 and to support the country's full return to market financing. Ireland successfully exited its programme on 8 December 2013 without requesting a precautionary credit line. Subsequently Irish credit default swap (CDS) spreads have tightened about 55 basis points (bps), down to 65 bps at the end of March 2014. Year to date, 10-year yields have moved lower by about 50 bps, which is evidence of continuing positive market sentiment toward Ireland's public debt sustainability.

Chart 11. Irish debt redemption profile: Initial versus extended maturities (in €bn)



Source: Central Bank of Cyprus

The first repayment of the EFSF loan to Ireland was extended from 2015 to 2029. The loan is expected to be fully repaid by 2042. The EFSF contributed €17.7 billion to a joint financing package of €85 billion for the Economic Adjustment Programme for Ireland agreed by international and bilateral lenders in November 2010.

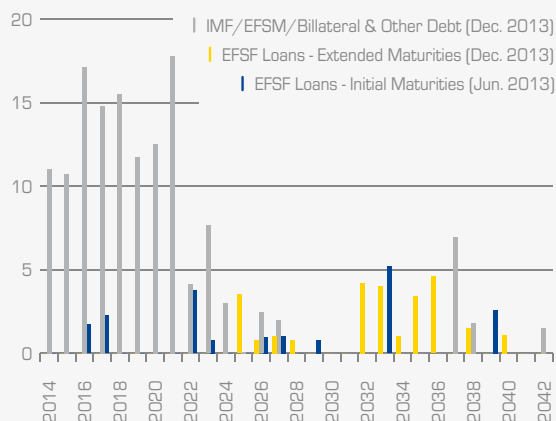
For EFSM loans the revised maturity dates of individual loan tranches will be determined closer to their original maturity dates because they have a back-to-back structure with bond issuance. Ireland is expected to start repaying its EFSM loans from 2027.

Portugal

Similarly, the extension of EFSF and EFSM loan maturities aims to improve Portugal's amortisation profile during the redemption hump of 2014-23 and to support the country's return to full market financing. Portugal also successfully exited its programme on 18 May 2014 without requesting a precautionary credit line. Portuguese credit default swap (CDS) spread stands currently (end of April) at 170 bps, down 180 bps from January 2014 to date. Ten-year yields have compressed about 250 bps in the first four months of 2014 alone, demonstrating investors' confidence in Portugal's public debt sustainability.

As a result of the maturity extension, principal repayment will start only from 2025 instead of 2015 and full repayment is expected by 2040. The EFSF contributed €26 billion to a joint financing package of €78 billion for the Economic Adjustment Programme for Portugal shared equally by the EFSM, the EFSF and the IMF. For EFSM loans the revised maturity dates of individual loans will be determined when they approach their original maturity dates, as is the case for Ireland. Portugal is expected to start repaying its EFSM loans from 2026.

Chart 12. Portuguese debt redemption profile: Initial versus extended maturities (in €bn)



Source: Central Bank of Cyprus

Funding activities

2013 review

In 2013 the ESM began its funding activities on the capital debt markets. The initial step was the establishment of a short-term funding programme, which was followed in October 2013 by the ESM's inaugural bond issue.

Short-term funding programme

On 8 January the ESM launched its financing activities on the debt markets with the auction of a 3-month bill. This raised €1.927 billion, with a weighted average yield of -0.0324% and was subscribed with a bid-to-cover ratio of 3.2. This initial bill was followed by the auction of a 6-month bill on 22 January.

The ESM continued to hold regular 3- and 6-month bill auctions throughout 2013. These were held using the Deutsche Bundesbank's ESM Bidding System (EBS). The auction dates for each quarter were communicated in advance through the ESM's newsletter.

The total amount raised in 2013 was €50.1 billion, with €16.2 billion outstanding debt on 31 December 2013.

The ESM bill programme has effectively replaced the EFSF bill programme, which was launched at the end of 2011. All maturing EFSF bills are refinanced through long-term funding from the EFSF or temporarily through the proceeds of ESM bills.

Long-term funding programme

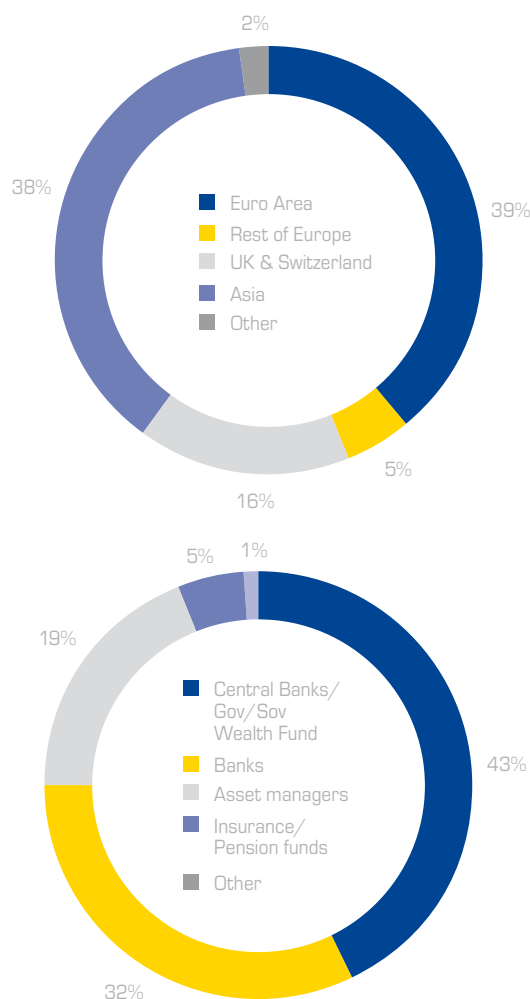
At the end of August 2013, the ESM announced the start of its long-term funding programme with a funding target for 2013 of €9 billion. The proceeds were to be used to finance disbursements for the macroeconomic adjustment programme for Cyprus and also the maturing notes that were provided to the Spanish government as part of the recapitalisation of the banking sector. The ESM announced that it would apply the same diversified funding strategy as the EFSF, using a wide variety of instruments and maturities. The ESM's funding concept rests on the issuance of benchmark-sized bonds and the strategic bill programme, complemented by other funding tools such as money market lines with banks and debt management offices (DMOs).

The initial objective of the ESM long-term funding strategy was to start building a liquid bond curve offering attractive investment opportunities in different maturities to a well-diversified investor base.

Before the inaugural bond issuance, the ESM embarked upon an extensive roadshow to reach investors in Europe and across Asia. A global conference call was also organised for investors who were unable to meet the ESM directly.

On 8 October, one year after its inauguration, the ESM launched its long-term funding programme with a €7 billion 5-year bond with a coupon of 1.25%. The issuance spread at reoffer was fixed at mid swap minus 1 basis point. The investor interest for this first ESM bond issue was exceptionally strong, with an order of close to €21 billion from 300 investors worldwide (Chart 13).

Chart 13. ESM Inaugural issue – Breakdown by region and investor type



Source: ESM

The second ESM bond was launched and priced on 12 November with the placement of a 10-year bond. Again the bond met very strong interest, with over €9.5 billion in orders received. This investor demand allowed the ESM to issue €3 billion at mid swap plus 19 basis points and thus complete the funding target for 2013 and raise an additional €1 billion.

Disbursements in kind

Another tool of the ESM funding strategy is the use of disbursements in kind. This has also been used by the EFSF within the context of the recapitalisation of the Greek banking sector. Instead of immediately providing a beneficiary Member State with cash raised from the debt markets, the ESM provides the beneficiary with ESM notes in kind. This process allows the ESM to fulfil its mission efficiently by providing timely support to beneficiary Member States in significant amounts without having

to enter the market. This therefore avoids volatility due to unexpected oversupply and gives the ESM the opportunity to raise the funds in the market over a longer period.

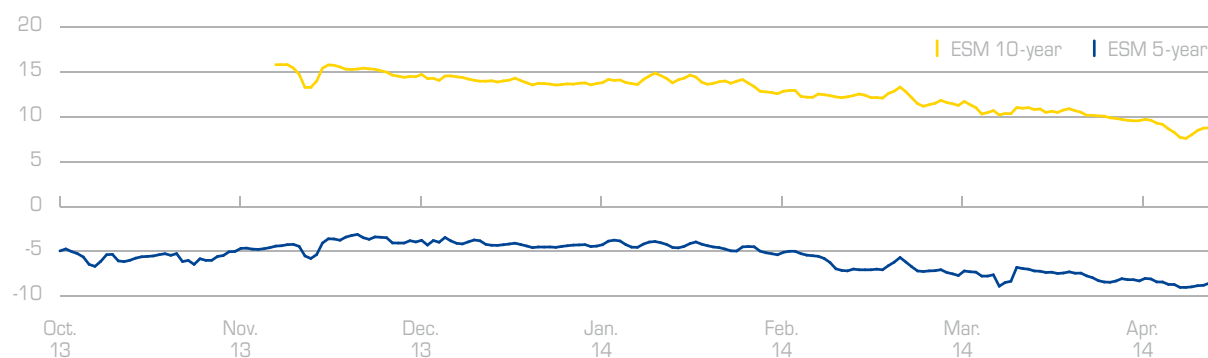
Notes in kind have been used for the recapitalisation of the Spanish banking sector, when the ESM provided the Spanish government with bills and bonds.

Using this same strategy, the ESM provided a €1.5 billion 18-month Floating Rate Note on 27 September to Cyprus as part of the macroeconomic adjustment programme. The Cypriot government used the notes for the recapitalisation of the cooperative banking sector.

Performance of ESM bonds

The two ESM bonds issued in 2013 have subsequently provided a positive performance in the secondary market: 1.25% ESM 2018 and the 2.125% ESM 2023 (Chart 14).

Chart 14. Swap spread of the first two ESM bonds



Source: ESM

ESM as a reference

The ESM is included in all the major sovereign, supranational and agency (SSA) and government bond indices:

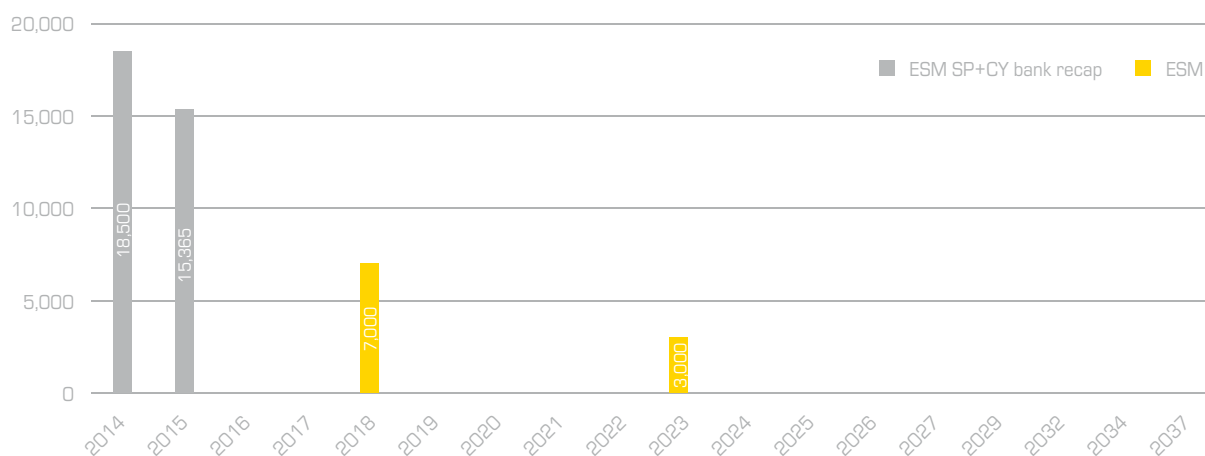
- BoAML EMU Broad Market index;
- JP Morgan Maggie Euro Credit index;
- iBoxx EUR Sub-sovereigns index;
- Citigroup World Broad Investment Grade index;
- Citigroup Euro Broad Investment Grade index;
- Barclays Capital Euro Aggregate index.

Outlook for 2014

In 2014, the ESM funding programme will be used to continue financing the programme for Cyprus. It will also be used to roll over the existing debt, specifically the bills and floating rate notes provided for the Spanish bank recapitalisation, into longer-term debt. The ESM intends to continue to build a liquid curve of benchmark bonds.

The ESM Maturity Profile (Chart 15) shows the amounts that the ESM has outstanding that will be required to roll over into longer-term debt, since the loans will be repaid only from 2022 onwards.

Chart 15. ESM Maturity Profile



Source: ESM

Applying the diversified funding strategy, the ESM will finance these amounts using a combination of the short-term programme through the bill auctions and the long-term programme through bonds issuance. Additional funding may be available through complementary sources such as money market lines with DMOs or banks from the ESM Market Group.

Short-term funding programme

The ESM bill auctions will continue on a regular basis. The amounts raised at each bill auction may vary in order to provide the ESM with some flexibility in its funding programme but normally are in the range of €1.5-3 billion for each auction. The auctions are usually held on Tuesday of the first and third full week of each month.

Long-term funding programme

The ESM long-term funding target for 2014 is €17 billion. Following its 5-year and 10-year bond issues in 2013, the ESM's funding strategy in 2014 is to continue to build a yield curve that will provide investors with opportunities across all maturities. The ESM issues benchmark-sized bonds and will be able to tap existing bonds should the opportunity arise.

In order to provide investors with as much clarity as possible, the ESM announces its funding target for each quarter.

Table 9. ESM long-term funding targets for 2014

€ billion	Q1	Q2	Q3	Q4	Total 2014
ESM long-term funding	6.0	4.0	0	7.0	17.0

On 25 February 2014, the ESM placed its first bond of 2014 with the launch of a 7-year bond, thus establishing a new point in the ESM yield curve. The issuance spread at reoffer was fixed at mid swap plus 7 basis points. The solid demand prompted the ESM to issue €6 billion.



João Sousa Gião

Senior Legal Officer for capital markets

Joined the EFSF in October 2011

Worked since 2002 at the Portuguese Securities Commission (CMVM), becoming Deputy Director of the Regulatory Policy and International Affairs Department.

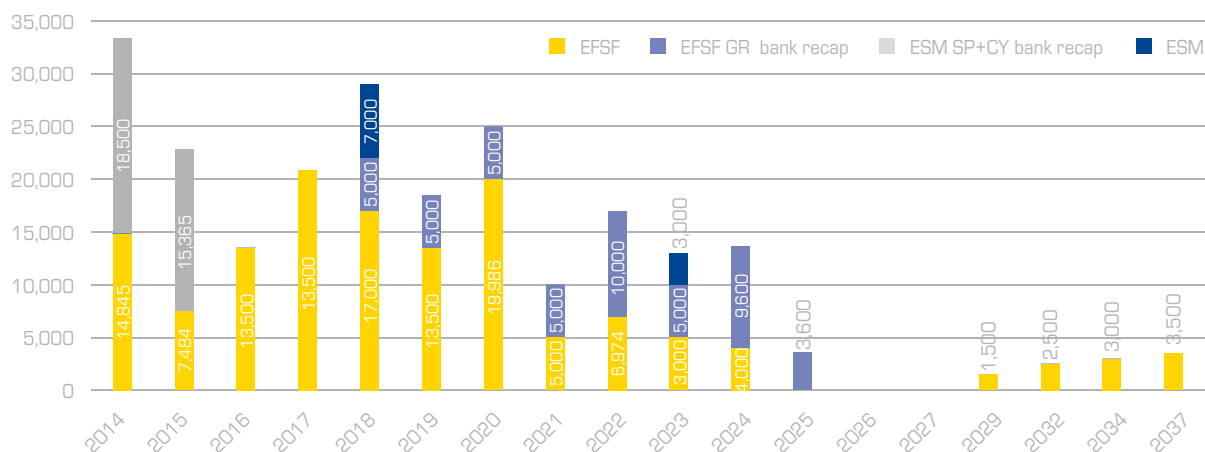
The opportunity to design from scratch ESM's funding instruments and to set up the legal framework that governs the investment of ESM's paid-in capital was a very exciting prospect. For a capital markets lawyer, this means taking part in some of the most strategically important, global and publicly scrutinised transactions in the world.

ESM and EFSF: one funding team and two issuers

When the ESM held investor roadshows in August and September ahead of its inaugural issue, a frequently-asked question was whether the ESM would take over the funding activities of the EFSF. The answer was a clear “No”. While the EFSF will not enter into any new programmes, it will remain a frequent issuer in the market in order to roll over the funding of the loans of existing programmes to Greece, Ireland and Portugal. It will also have to roll over existing debt into longer maturities. Only once the outstanding debt and loans have been repaid (the final loan matures in 2051) will the EFSF close down (Chart 16).

The ESM funding team therefore manages the funding programmes for both the EFSF and ESM.

Chart 16. EFSF and ESM Maturity Profile



Source: ESM

To provide transparency and clarity regarding both funding programmes, the ESM sends out a quarterly newsletter. This is sent to over 600 investors and market participants, and posted on the ESM website: www.esm.europa.eu/about/publications/index.htm.

It covers the key features of the funding strategy over the previous quarter and presents the main information for the next quarter. Notably this includes the weeks when the EFSF and ESM could potentially issue a bond and the dates of the bill auctions.

Box 7. Investor relations

A stable and well-diversified investor base is crucial to the success of the ESM's funding programme and therefore to the organisation's ability to fulfil its mission. Building on the extensive roadshows the ESM held to prepare for the launch of its long-term funding, the ESM holds regular meetings and roadshows with investors. As the ESM is a unique institution, it is essential that investors understand its structure and organisation. In addition, these meetings with investors have provided

good opportunities to share information on developments in the euro area, particularly progress in overcoming the crisis.

A dedicated Investor Relations department has been created to provide ESM investors with as much information as possible, to be available to answer any questions and to maintain a continuous dialogue with investors to properly understand their requirements.

Overview of investor relations activity in 2013**37** cities
visited**32** conferences
attended**103** one-on-one meetings
with investors



Siegfried Ruhl

Head of Funding

Joined the ESM in January 2013

Worked in Bundesrepublik Deutschland Finanzagentur since 2002 and was involved in the set-up/initiation of EFSF/ ESM. Started career at the Bundesbank.

Setting up a new issuer from scratch is a once-in-a-lifetime opportunity. The environment is challenging and we are constantly looking for innovative solutions. It is also very rewarding to know that the funding we raise serves a vital role in the stability of Europe.

Box 8. The ESM's credit rating and the regulatory treatment of its issuances

The ESM is committed to maintaining a very high level of creditworthiness in order to successfully fulfil its mandate. Throughout 2013 it continued to rank among the most creditworthy international financial institutions, with a long-term rating of AAA with a stable outlook and a short-term rating of F1+ assigned by Fitch, as well as a long-term rating of Aa1 with negative outlook and short-term rating of P-1 assigned by Moody's.

The ESM's very high credit rating derives from the institution's intrinsic strength, determined by the following key elements:

- The ESM has a higher paid-in capital (slightly over €80 billion) than any other international financial institution. The ratio between its paid-in capital and the callable capital (€621.7 billion) also compares favourably with its peers.
- A lending capacity of €500 billion compared with a total subscribed capital of €701.9 billion highlights the low leverage of the institution.
- The paid-in capital is not used for lending and is invested conservatively in assets of highest creditworthiness and liquidity. These assets also contribute to the coverage of due payments arising from the ESM's liabilities in the next 12 months, underpinning a strong liquidity position.
- The ESM's Early Warning System, entailing reviews of the financial conditions of the borrowers well in

advance of repayments, and its preferred creditor status are strong credit-enhancing factors.

The credit assessments also acknowledge the strong support provided by the euro area Member States through a unique and exceptionally robust capital call mechanism, which allows the ESM's Managing Director to call capital to avoid a default on obligations without requiring approval by the Board of Governors and Board of Directors. In this regard, a high share (61.4%) of callable capital provided by shareholders rated AA- and above by Fitch is also emphasised.

In addition to credit agencies' views, the regulatory treatment of ESM debt is also important for maintaining its diversified investor base. On 20 December 2013 the European Banking Authority (EBA) recommended to consider securities issued by the ESM, among other asset groups, as transferable assets of extremely high liquidity and credit quality. This recommendation is expected to be included in the delegated act specifying liquidity coverage requirements the European Commission is empowered to adopt by the end of June 2014, as per Article 460 of the Capital Requirements Regulation (CRR).

A recommendation to apply a favourable regulatory treatment to ESM issuances was also included in the announcement on 18 March 2014 by the Basel Committee that the ESM will be included in the list of entities receiving a 0% risk weight. Claims on the ESM will therefore be treated as Level 1 High Quality Liquid Assets (HQLA).

Investment and Treasury

Investment Policy

The ESM Investment Policy ensures that investment of the paid-in capital is done in an efficient and conservative manner. By preserving the paid-in capital, the Policy ensures that the maximum ESM lending capacity remains available.

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

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

The Managing Director is responsible for implementing the Investment Policy and for setting up the appropriate governance framework.

Investment and Treasury activities

Article 6(2) of the ESM Investment Policy Guidelines stipulates that:

"The Managing Director shall ensure a smooth implementation of the ESM Investment Policy guidelines, once paid-in capital has been paid. As an immediate investment of the capital payments along the targeted Investment Policy might lead to market price impacts, some temporary divergence, namely a higher share in short-term and very liquid assets, shall be tolerated."

The ESM's investment strategy in 2013 was influenced mainly by the payments of the third and fourth €16 billion instalments of paid-in capital by ESM Members, in April and October respectively, following the first two instalments paid in at the end of October 2012. As the ESM aims to ensure capital preservation, not only to reduce its market risk exposure but also to be a neutral market participant, it has designed a process to ensure all these objectives are met.

In general, 2013 was characterized by a low-yield environment in debt markets and credit rating downgrades across both sovereign and banking entities. As in 2012, the past year also highlighted the increased inter-linkages between countries' creditworthiness, banking sectors and economic performance which can amplify systemic risks. However, yields managed to climb and spreads to tighten by the end of December, as the euro area macro-economic environment improved, specifically in the peripheral countries. The German government bond 2-year, 5-year and 10-year yields were up respectively by 22, 62 and 61 basis points with a steeper 2-year–5-year curve over 2013. The two paid-in capital instalments in 2013, made at the end of April and October respectively, occurred in a near zero yield environment for maturities up to two years.

Despite these challenges, the ESM's investment strategy was regularly adapted to the rapidly changing environment of the global financial markets, with the primary objectives of strengthening the credit quality and liquidity profile of the investment portfolios while limiting the volatility of their returns. Indeed, in the context of this very low yield environment and the high risk of negative returns, the overriding objective was preservation of capital rather than return generation.

Another important feature of the strategy during the investment of the paid-in capital instalments was being cognisant of market liquidity conditions and avoiding an impact on market prices. As a result, the two paid-in capital instalments were invested progressively, without affecting the targeted market segments. The ESM's Investment and Treasury implemented a conservative asset mix prioritizing high credit quality issuers and investing in low yield but low risk instruments and strategies, including a high initial cash cushion deposited with central banks, while concurrently constraining the average portfolio modified duration to the lower bounds of the target ranges, as well as limiting portfolio curve exposure.

Looking beyond the 2013 financial year, during the first quarter of 2014 the investment strategy remained unchanged. Improved market conditions offered limited opportunities for return generation, such as modest duration extensions to capitalize on relatively steeper yield curves for short-term maturities and take advantage of carry and roll-down effects.

All ESM investment and treasury activities continue to be thoroughly reviewed and are subject to a wide range of controls carried out by Middle Office to ensure full compliance of these activities with relevant policies.

Based on the successful strategy for the investment of paid-in capital instalments during 2013, a similar prudent and neutral approach will be implemented for the deployment of the last instalment of the paid-in capital scheduled for the end of April 2014, in the context of prevailing market conditions.



Yasser Abdoulaye

Senior Portfolio Manager

Joined ESM in December 2012

Worked as Senior Investment Officer at African Development Bank's Treasury in Tunis for over five years, after seven years at Natixis Asset Management in Paris as Fixed Income Portfolio Manager.

The ESM is a productive workplace as it encourages staff in creative thinking and discipline, in a good working and learning environment at the edge of recent technology in every aspect of the institution's activities.

Box 9. Investment and Treasury performance

During 2013 the aggregate performance of the paid-in capital, which represents the profit and loss relative to the amount of invested assets, was positive.

This performance was achieved despite an adverse yield environment. Throughout 2013 relevant yield curves steepened: as a reference, the Germany 2-year and 5-year yields were up by 22 bps and 62 bps respectively and France 2-year and 5-year yields rose by 22 bps and 59 bps. The ESM's prudent investment strategy, consisting of progressive investment of the proceeds of the paid-in capital over time, mitigated the negative impact of decreasing prices.

In 2013, the individual performance of both the short-term and long-term portfolios was positive and relatively better than the respective comparable index (benchmark). For the short-term portfolio the 2013 performance of the most common relevant index was 8.5 bps and the performance of a generic 3M German bill was -0.2 bps; with regard to the medium- to long-term portfolio the performance in 2013 of the most common relevant index was 5.1 bps and for a generic 2Y German bond it was -2 bps.

The performance has remained positive during the first four months of 2014 and has outperformed the most common relevant indices.

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 of which documents are publicly available.

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

- To follow a prudent approach to risk-taking in order to limit potential losses and to ensure continuity in fulfilling the ESM's mandate and meeting its commitments.
- To maintain minimum capital requirements in order to ensure the highest creditworthiness and to avoid unexpected capital calls.
- To 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 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. 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 mechanisms for the governance of risk management within the ESM include the various committees and decision-making bodies responsible for adherence and conformity with the ESM risk management framework as well as how authority for decisions is delegated.

The Board of Governors delegates authority and accountability for establishment of the ESM risk management framework to the Board of Directors and implementation to the Managing Director. In addition, two risk committees have been established pursuant to the High Level Principles for Risk Management:

- The Board Risk Committee is a permanent committee of the Board of Directors. It advises the Board of Directors on the overall current and future risk appetite, and assists the Board of Directors in reviewing and overseeing the development and implementation of the ESM risk management framework by the Managing Director.

- The Internal Risk Committee is a permanent internal committee of the ESM directly empowered by delegated authority from the Managing Director, whose members are the Management Board and the Head of Risk. It considers and decides upon any matters of evaluating, monitoring and approving practices regarding the implementation of the ESM risk management framework. It examines the overall risk profile and material risk developments, and reviews the control environment.

Risk appetite

A Risk Appetite Statement has been developed for the ESM to provide a statement of the appetite for risk that the ESM Board of Directors is willing to accept in the execution of the organisation's mandate. This risk appetite is then cascaded by ESM management and the Risk department into relevant aspects of governance, policies, frameworks and individual limits to ensure that all aspects of 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. These provide targets for certain qualitative and quantitative measures relating to target rating, capital adequacy, liquidity, ALM and funding, financial and non-financial risks. These detailed provisions for risk appetite objectives have been designed to accord with other Board-approved policies, such as the Investment Policy, and are overseen and monitored by the Board Risk Committee.

Risk culture

The establishment of 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 the Managing Director and the Management Board, risk culture in the ESM is founded on a close alignment throughout the organisation with the objectives of the risk management framework. Such a culture embeds and operationalises an independent discipline, which in turn ensures rigorous challenge and objectivity in decision-making.

Three Lines of Defence

Risk management is a shared responsibility between the various parts of the organisation. The Three Lines of Defence concept, as established in the High Level Principles and expected by stakeholders as best practice, sets out the principles for ensuring the appropriate segregation of powers and duties, clearly drawn lines of authority, and distinct roles and responsibilities for the management and control of risk. ESM staff have a direct responsibility for understanding and managing risk, and are subject to the ESM Code of Conduct.

1st Line of Defence

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. Each of the First Line of Defence areas conducts its activities to meet the objectives of the ESM in line with stated risk appetite, operates within the limits, policies and guidelines set by the Risk department and other control functions (such as Compliance and Legal), and is responsible for the risks taken in performing its function. All staff are regarded as the First Line of Defence with respect to non-financial risks, particularly compliance and operational risks.

2nd Line of Defence

This is principally an independent risk management function responsible for ensuring that risks assumed by the business are appropriately managed and controlled. It proposes mandates, guidelines, policies and limits to ensure risk-taking remains within the institution's risk appetite, and provides reporting and monitoring of the organisation's compliance with risk governance. The Risk department exercises independent central oversight of risk and ensures the comprehensiveness and consistent implementation of the risk management framework by all business functions.

3rd Line of Defence

Internal Audit is an independent function responsible for providing a reasonable assurance that the risk management function is operating properly and efficiently. Internal Audit reports to the Managing Director and has direct access to the Board of Auditors on issues related to risk management. It provides independent assurance of the robustness and correct application of risk management processes through identification, assessment, monitoring and management stages, as well as identifying any operational weaknesses or defects.

Risk management process

The ESM has chosen to implement a systematic process for the management of the various types of risk to which the organisation is exposed in the course of executing its mandate. The management of risk at the ESM is a four-step process which applies equally to the management of both financial and non-financial risks:

- **Risk identification**
the identification of all material risk exposures, both financial (credit, market and liquidity risk) and non-financial.
- **Risk assessment**
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. In order to fulfil this mandate successfully, the ESM needs to maintain the highest creditworthiness so as both to minimise the cost of borrowing to 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 types of financial and non-financial risks. These risks are a function of the nature of the ESM's mandate and operational activities, as well as its operating model and financial policies. Appropriate procedures and processes are implemented to identify, assess and measure, monitor and manage these risks.

Credit risk

The foundation for the ESM's credit risk framework has been laid down in the ESM's Investment Policy and the High Level Principles for Risk Management approved by the Board of Directors. In addition, the main principles of the risk management framework have been defined in the ESM's Risk Policy. These are complemented by credit risk policies adopted by the Internal Risk Committee.

Credit risk is the potential for loss arising from inability of a counterparty, issuer, insurer, or other obligor to fulfil its contractual obligations. The ESM is exposed to credit risk from two sources: (1) lending and stability support activities, and (2) investment and funding operations.

1 Credit risk from lending is the risk of loss due to the ESM lending to beneficiary Member States (those to which stability support has been extended when facing financial difficulties) should they not fulfil their contractual obligations. While its lending operations result in significant lending exposure, the ESM Treaty incorporates two measures for controlling the credit risk:

- Heads of State or Government have stated that the ESM loans will enjoy preferred creditor status in a similar fashion to those of the IMF, while accepting preferred creditor status of the IMF over the ESM.
- 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").

2 The ESM encounters two main types of credit risk in its investment and funding operations:

- Issuer and counterparty risk – the risk of financial loss as a result of the non-fulfilment of contractual obligations.
- Credit concentration risk – the potential for financial 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 with each other.

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

Credit exposure is mitigated by a set of credit limits and by minimum credit quality thresholds. Compliance with these thresholds is 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. Credit risk exposures, and compliance with credit risk rules, are measured and monitored daily.

Market risk

Market risk is the risk of losses arising from changes in the values of financial assets and liabilities (including off balance sheet items) due to fluctuations in market factors such as interest rates, foreign exchanges and prices of 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 the lending and funding activity, and non-structural in relation to the investment of the paid-in capital.

The main market risk that the ESM faces is interest rate risk, which is the potential for 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** is 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** is 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 the maturity of the liabilities used to fund them.

Non-Structural

- **General interest rate risk** is 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** is 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.

Structural interest rate risk is controlled by reference to cashflow projections performed by the ALM function, leading to a requirement for available cash to repay maturing bills and bonds, supported by a short-term liquidity buffer as defined in the Investment Policy. The ESM is required to maintain coverage of all outflows up to one year using the liquidity buffer and a set proportion 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 (VaR) limits for each tranche of the paid-in capital as described in the Investment Policy. These are monitored by means of a VaR calculation, which is performed daily on the portfolio using a 99% confidence level. The daily values are then converted to longer-term values and compared with risk appetite.

VaR 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 then reviewed at the Internal Risk Committee and, in some cases, at the Board Risk Committee.

The ESM recognises other market risks. Credit spread risk is 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 is the potential for loss arising from changes in the exchange rates. Since the ESM currently funds and invests only in the euro, this risk is not present. The ESM also currently does not use derivative instruments in any of its activities.

Table 10 gives a daily and annualised VaR comparison between the end of 2012 and the end of 2013.

Table 10. Daily and annualised VaR comparison, 2012 and 2013

	Portfolio value in € million	1 day Value-at-Risk in € million	Daily % of portfolio value	Annualised % of portfolio value
As at 31.12.2013	78,307	56	0.07%	1.13%
As at 31.12.2012	32,973	19	0.06%	0.93%

Liquidity risk

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

- Funding liquidity risk is the risk of losses 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 is the potential loss arising from concentrations in assets and liabilities as major sources of liquidity, particularly in times of market stress.

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: (1) it must comply with sound liquidity risk management principles; and (2) 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 2013, the liquidity buffer stood at €5.0 billion; on average in 2013 it was €5.0 billion.

The ESM continually monitors funding conditions, and stresses its projections of asset and liability cashflows based on a number of alternate assumptions. The organi-

sation 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 30).

A third type of liquidity risk, market liquidity risk, is the potential for 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 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,



Françoise Blondeel

Head of Middle and Back Office

Joined the ESM in March 2012

Worked previously for the French Ministry of Finance and the DMO in the post trade and risk department.

I was very enthusiastic to help build an adequate control framework for ESM financial trades. I very much enjoy working at creating new public institutions where a spirit of adventure, professionalism and commitment coexist.

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 known as Basel II (2006), namely risks related to:

- Execution, delivery and process management
- Counterparts, products and business practices
- 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. Follow-up of events takes place to establish causes and agree on mitigating actions. Formal escalation procedures are established involving the Internal Risk Committee and the Board Risk Committee in order to ensure active involvement of senior management and, where necessary, the Board of Directors in addressing operational risk issues.

The above approach to operational risk management 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.

Reputational risk is 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 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 is the risk of loss as a result of: (1) inadequate or inefficient documentation, legal capacity, enforceability of national and international laws, (2) litigation against the ESM or its assets and (3) 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 is 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 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 confidentiality of information. 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.

Political risk is 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 ESM Board of Governors and closely monitored by the ESM Managing Director.



Eleftheria Christakou

Communications Officer

Joined the ESM in March 2013

Previously held communications positions in Eurobank, Hellenic World Foundation and the Greek Ministry of Finance; also a visiting academic lecturer.

I joined the ESM in the midst of a crucial period for Greece, my country of origin, having a clear vision, which eventually became everyday work reality; effectively contribute to the effort of assisting euro area countries with financial difficulties, and personally evolve as a communications professional.

Transparency and communication

Since its creation in October 2012, the ESM has proved its commitment to transparency. It communicates frequently with its stakeholders and also with the general public. Those interested in the ESM are entitled to understand what the organisation is and what it does. This commitment was demonstrated in 2013 through the consistent presence of the ESM in the public domain.

The ESM's communication is shaped by its specific mandate and institutional nature. The ESM's mission is to provide financial assistance against conditionality to safeguard financial stability in the euro area as a whole or in its Member States. The institution's actions are directly controlled by its shareholders, the 18 euro area Member States. As the shareholders' political appointee, the Managing Director is at the centre of the organisation's communication.

Following continuous interest from the public, the Managing Director and ESM senior staff made numerous media appearances. This helped to explain the ESM's actions, 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. Given the global interest in the currency union and the ESM's global investor base, there is also a significant global communication effort.

The Managing Director participates in the press conferences held at the conclusion of the monthly euro area finance ministers' meetings. On an ad hoc basis, the Managing Director also visited individual euro area Member States.

The Managing Director and ESM senior staff participated throughout 2013 in several meetings and conferences worldwide, attended by policy-makers. 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 by the European Parliament in 2013, the Managing Director attended meetings of the Economic and Monetary Affairs Committee. Since the ESM is not an EU institution, this participation is done on an ad hoc basis with a view to inform and debate with the European people's representatives. In its Luxembourg headquarters the ESM regularly accommodated requests of visitor groups for on-site institutional presentations.

Press releases are the standard means of communication for all important news regarding the ESM. Communication of important topics, such as Spain's ESM programme exit in December 2013, is reinforced by comprehensive information packages. Public communication is further underpinned by the use of social media.

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. The 2012 Annual Report was the first and, although it covered only three months of activities, it presented the new institution to all interested audiences.

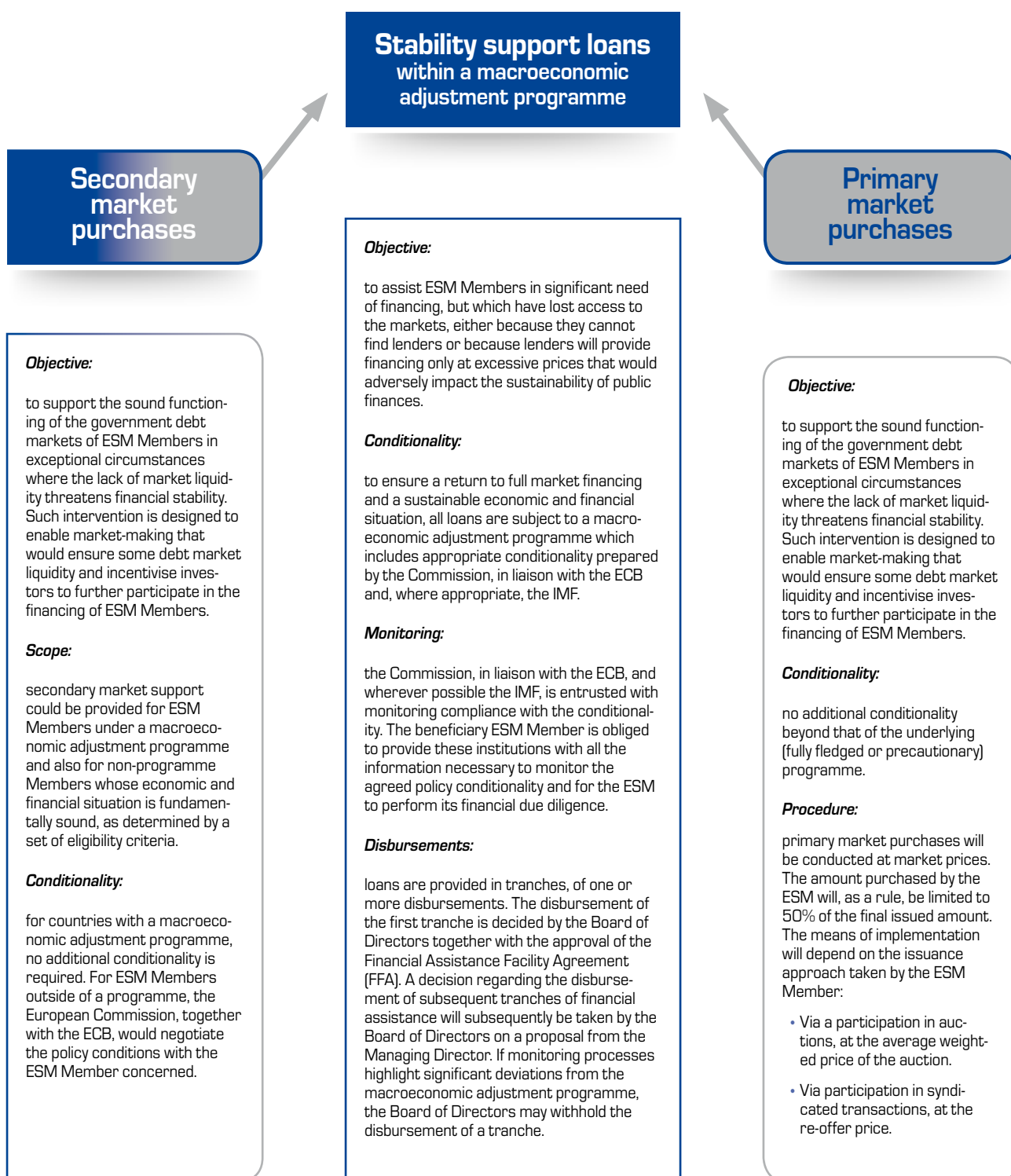
The ESM's shareholders, other stakeholders and the public can find a comprehensive and regularly updated set of relevant information, such as legal documents, financing agreements, institutional information, and programme and investor-related information, on the ESM website.

Chapter

3

Institutional Framework and Organisation

ESM financial assistance instruments



Precautionary credit line

Objective:

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

Two types of ESM credit line are available:

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

- **Precautionary Conditioned Credit Line (PCCL):** available to a euro area 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. The beneficiary country is obliged to respect these criteria after the PCCL is granted.
- **Enhanced conditions credit line (ECCL):** access open to all euro area Member States whose general economic and financial situation remains sound but that do not comply with some of the eligibility criteria for accessing a PCCL. The beneficiary ESM Member is obliged to adopt corrective measures aimed at addressing such weaknesses and avoiding any future problems in respect of access to market financing. It must also ensure continuous adherence to the eligibility criteria that were considered met when the credit line was granted.

Once the credit line is granted, the beneficiary ESM Member has the flexibility to request the draw-down of 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 European Commission. The scope of surveillance includes the beneficiary country's financial condition and developments in its financial system. It is also obliged to carry out and report to assess the reliability, completeness and accuracy of the public accounts for the purpose of the excessive deficit procedure.

Loans for indirect bank recapitalisation

Objective:

to preserve the financial stability of the euro area by addressing cases in which the roots of a crisis are primarily in the financial sector and not directly related to fiscal or structural policies. Loans limit the contagion of financial stress by ensuring that a government has the capacity to finance recapitalisation at sustainable borrowing costs and repair the financial sector to eliminate vulnerabilities.

Eligibility:

the beneficiary Member State should demonstrate an inability to:

- Meet capital shortfalls via private sector solutions such as tapping new market investors or existing shareholders.
- Recapitalise the institution(s) without generating adverse effects for its own financial stability and fiscal sustainability.

The financial institution(s) concerned should be of systemic relevance or pose a serious threat to the financial stability of the euro area or its Member States. The beneficiary ESM Member should also demonstrate its ability to reimburse the loan granted.

Conditionality:

will apply in the domains of financial supervision, corporate governance and domestic law relating to restructuring/resolution. The policy conditions are negotiated by the European Commission in liaison with the ECB and a relevant European Supervisory Authority (EBA, ESMA or EIOPA).

Monitoring:

compliance with EU State aid rules is enforced by the European Commission, which also monitors other policy conditions with the ECB and the relevant European Supervisory Authority.

Governance

ESM shareholders

The ESM's shareholders are the 18 euro area Member States. The contribution key for subscribing to ESM authorised capital is based on the ECB capital contribution key, which reflects the respective country's share in the total population and GDP of the EU. Member States with a GDP per capita of less than 75% of the EU average will benefit from a temporary correction for a period of 12 years after their date of adoption of the euro.

Latvia's accession

In July 2013, the Council of the European Union formally approved Latvia's accession to the euro area from 1 January 2014. According to the ESM Treaty, all euro area Member States will become ESM Members.

Following Latvia's application to join the ESM, the Board of Governors approved its application in October 2013 and Latvia officially became the ESM's 18th Member on 13 March 2014.

Latvia's ESM capital contribution key was set at 0.2757%. With the correction mechanism, Latvia's capital subscription is €1.93 billion, including €221.2 million in paid-in



Niyat Habtemariam

Corporate Governance and Audit Officer

Joined the ESM in August 2013

Worked as a corporate governance analyst in Brussels and in London for MSCI Inc., a provider of financial advisory services for institutional investors.

The ESM is a very special place to work – a very young, dynamic and comparably small institution. I am surrounded by exceptionally motivated, bright and capable colleagues. I feel that I am constantly learning new and exciting things, which I find very stimulating and rewarding.

capital, which will be paid in five annual instalments of €44.24 million. Latvia paid the first instalment on 19 March 2014, and the remaining four instalments will be paid annually until 2018.

Latvia's accession in 2014 does not affect the capital subscriptions of the other ESM Members, which remain the same.

Table 11. Shares and Subscribed Capital per ESM Member

ESM Members	ESM key (%)	Number of shares	Subscribed capital (€ million)
Belgium	3.4675	243,397	24,339.7
Germany	27.0716	1,900,248	190,024.8
Estonia	0.1855	13,020	1,302.0
Ireland	1.5878	111,454	11,145.4
Greece	2.8089	197,169	19,716.9
Spain	11.8709	833,259	83,325.9
France	20.3297	1,427,013	142,701.3
Italy	17.8643	1,253,959	125,395.9
Cyprus	0.1957	13,734	1,373.4
Latvia	0.2757	19,353	1,935.3
Luxembourg	0.2497	17,528	1,752.8
Malta	0.0729	5,117	511.7
Netherlands	5.7012	400,190	40,019.0
Austria	2.7757	194,838	19,483.8
Portugal	2.5023	175,644	17,564.4
Slovenia	0.4264	29,932	2,993.2
Slovakia	0.8217	57,680	5,768.0
Finland	1.7924	125,818	12,581.8
Total	100	7,019,353	701,935.3

Note: As at 13 March 2014

Governance structure



On 11 February 2013, **Jeroen Dijsselbloem** succeeded Jean-Claude Juncker as the Chairperson of the Board of Governors.

Board of Governors

The Board of Governors is the ESM's highest decision-making body; it consists of government representatives of each ESM Member. The European Commission and the ECB may participate in its meetings as observers.

Board of Auditors

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

Board of Directors

The Board of Directors consists of senior officials from ESM Members who have high competence in economic and financial matters. The Board has 18 Directors, and the ECB and EC may participate in the meetings as observers. The Board of Directors' meetings are chaired by the Managing Director.



Klaus Regling
Managing Director,
chairs meetings of the
Board of Directors

Risk Committee

The Risk Committee advises the Board of Directors on the overall current and future risk appetite and strategy. It also assists the Board of Directors in ensuring that the risk management framework is implemented by the Managing Director. It comprises five Directors elected from among their peers.

Managing Director

The Managing Director is responsible for conducting the current business of the ESM under the direction of the Board of Directors, which he chairs. The Managing Director is the legal representative and the chief of staff of the ESM. The Management Board assists the Managing Director in conducting the current business of the ESM.

Compensation Committee

The Compensation Committee advises the Board of Directors and the Managing Director in matters of staff compensation, and performs periodic revision of the compensation framework, annual salary mass and evolution of salary band boundaries. It comprises five Directors elected from among their peers.



Annual meeting of the ESM Board of Governors, 20 June 2013

Board of Governors

Key decisions

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

In 2013, the Board of Governors held six meetings and took the following key decisions:

- Appointed the new President of the Eurogroup as the chairperson of the Board of Governors (11 February 2013).
- Approved granting stability support to Cyprus (24 April 2013).
- Approved the 2012 Annual Report (20 June 2013).
- Approved the accession of Latvia to the ESM (23 October 2013).
- Appointed Mr Igors Ludboržs as a new member of the Board of Auditors to replace Mr Harald Noack (16 December 2013).

Members of the Board of Governors

Belgium

Koen Geens

Minister of Finance,
replaced Steven Vanackere, Minister of Finance
on 6 March 2013

Germany

Wolfgang Schäuble

Federal Minister of Finance

Estonia

Jürgen Ligi

Minister of Finance

Ireland

Michael Noonan

Minister of Finance

Greece

Giannis Stournaras

Minister of Finance

Spain

Luis de Guindos

Minister of Finance

France

Michel Sapin

Minister of Finance,
replaced Pierre Moscovici, Minister of Economy,
Finance and Industry on 2 April 2014

Italy

Pier Carlo Padoan

Minister of Economy and Finance,
replaced Fabrizio Saccomanni, Minister of Economy and
Finance on 22 February 2014,
replaced Vittorio Grilli, Minister of Economy and Finance
on 28 April 2013

Cyprus

Harris Georgiades

Minister of Finance,
replaced Michael Sarris, Minister of Finance
on 3 April 2013,
replaced Vassos Shiarly, Minister of Finance
on 28 February 2013

Latvia

Andris Vilks

Minister of Finance,
Member of the Board since 13 March 2014

Luxembourg

Pierre Gramegna

Minister of Finance,
replaced Luc Frieden, Minister of Finance
on 4 December 2013

Malta

Edward Scicluna

Minister for Finance,
replaced Tonio Fenech, Minister of Finance
on 13 March 2013

The Netherlands

Jeroen Dijsselbloem

Minister of Finance

Austria

Michael Spindelegger

Federal Minister of Finance,
replaced Maria Fekter, Federal Minister of Finance
on 19 February 2014

Portugal

Maria Luís Albuquerque

Minister of State and Finance, replaced Vitor Gaspar,
Minister of State and Finance
on 2 July 2013

Slovenia

Uroš Čufer

Minister of Finance,
replaced Janez Šušteršič, Minister of Finance
on 21 March 2013

Slovakia

Peter Kažimír

Deputy Prime Minister and Minister
of Finance

Finland

Jutta Urpilainen

Minister of Finance

Board of Directors

Key decisions

The Board of Directors ensures that the ESM is run in accordance with its Treaty and By-Laws. It takes decisions as provided for by the ESM Treaty or decisions delegated to it by the Board of Governors. In 2013, the Board of Directors held 11 meetings and took the following key decisions:

- Approved the disbursement of the second tranche to Spain (28 January 2013).
- Appointed a new member of the Compensation Committee (21 March 2013).
- Adopted the Terms of Reference and Rules of Procedure of the Risk Committee of the Board of Directors (21 March 2013).
- Approved signing of the Financial Assistance Facility Agreement between the ESM, the Republic of Cyprus and the Central Bank of Cyprus (3 May 2013).
- Approved the disbursement of the first three tranches to Cyprus (3 May 2013, 16 September 2013, and 17 December 2013).
- Approved the ESM Risk Policy (16 September 2013).
- Approved the Statute of the Administrative Tribunal of the ESM (29 October 2013).
- Approved the administrative budget for the financial year 2014 (28 November 2013).
- Updated the ESM diversified funding strategy (28 November 2013).

Key decisions in 2014 (until end of April):

- Approved the ESM Code of Conduct (12 March 2014).
- Approved the Early Warning System Procedure (24 March 2014).
- Appointed a new member and chairperson of the Compensation Committee (24 April 2014).
- Approved the disbursement of the fourth tranche to Cyprus (2 April 2014)

Members of the Board of Directors



Belgium

Jozef Kortleven

Counselor General,
Ministry of Finance



Germany

Thomas Steffen

State Secretary,
Federal Ministry of Finance, Member of the
Compensation Committee



Estonia

Märten Ross

Deputy Secretary General for Financial
Policy and External Relations, Ministry of
Finance, replaced Martin Pöder, Deputy
Secretary General for Financial Policy and
External Relations, Ministry of Finance on
21 October 2013



Ireland

James O'Brien

Second Secretary General, EU and
International Division, Department
of Finance, Member of the Compensation
Committee



Greece

Paniagiotis Tsakloglou

Chairman of the Council of Economic
Advisors, Ministry of Finance



Spain

Iñigo Fernandez de Mesa Vargas

Secretary General of Treasury,
Member of the Compensation Committee



France

Ramon Fernandez

Director General of the Treasury,
Ministry of Economy, Finance and Industry



The Netherlands

Hans Vijlbrief

Treasurer-general of the Ministry of Finance,
Member of the Board Risk Committee



Italy

Vincenzo La Via

Director General of the Treasury,
Ministry of Economy and Finance,
Chairman of the Board Risk Committee



Austria

Harald Waiglein

Director General for Economic Policy and
Financial Markets of the Federal
Ministry of Finance,
Member of the Board Risk Committee



Cyprus

George Panteli

Senior Economic Officer,
Ministry of Finance,
replaced Andreas Charalambous,
Director, Ministry of Finance
on 29 April 2013



Portugal

Isabel Castelo Branco

Secretary of State of the Treasury, Member
of the Board Risk Committee, replaced João
Sousa, Chief Economist, Ministry of Finance,
Member of the Board Risk Committee,
on 31 January 2014



Latvia

Sanita Bajāre

State Secretary,
Ministry of Finance,
Member of the Board since
13 March 2014



Slovenia

Mitja Mavko

State Secretary, Ministry of Finance,
replaced Marko Pogačnik, State Secretary,
Ministry of Finance on 17 April 2013,
replaced Dejan Krušec, State Secretary,
Ministry of Finance, Member of the
Compensation Committee,
on 7 February 2013



Luxembourg

Isabelle Goubin

Director of the Treasury, Ministry of Finance,
Member of Compensation Committee,
replaced Georges Heinrich,
Director of the Treasury, Chairman of the
Compensation Committee,
on 19 March 2014



Slovakia

Vazil Hudák

State Secretary, Ministry of Finance
Member of the Board Risk Committee



Malta

Alfred Camilleri

Permanent Secretary,
Ministry of Finance, Chairman of the
Compensation Committee



Finland

Tuomas Saarenheimo

Permanent Under-Secretary, Ministry of
Finance, replaced Martti Hetemäki,
Permanent State Under-Secretary,
Ministry of Finance
on 12 September 2013

Members of the Board of Auditors



Katarína Kaszasová
Chairperson
as of 21 March 2014,
former Vice
Chairperson as of
8 October 2012



Ulrich Graf
Vice Chairperson
as of 21 March 2014,
Member since
8 October 2012



Marc Gengler
Member as of
8 October 2012



Igors Ludboržs
Member as of
17 December 2013
replacing Harald Noack



Jules Muis
Member as of
8 October 2012

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 to ensure Board continuity. New members to the Board of Auditors will be appointed for non-renewable terms of three years.

The Board of Auditors held 11 meetings in 2013. Additionally, the Board of Auditors had two internal conference calls and met once with the Board of Directors as well as with the Risk Committee of the Board of Directors. During its monthly meetings, the Board of Auditors was provided with regular updates on ESM activities, ESM governing bodies and other relevant issues and developments by the ESM management and senior staff. The Board of Auditors was also provided with presentations and written opinions by ESM management as well as external experts on specific topics requested by the Board of Auditors. Lastly, the Board of Auditors regularly met with the internal audit function and monitored the work and independence of the external auditors.

The Board of Auditors inspects ESM accounts and verifies that the operational accounts and the balance sheet are in order. Further, it audits the regularity, compliance, performance and risk management of the ESM in accordance with international auditing standards and monitors the ESM's internal and external audit processes and their results. In fulfilling its role, the Board of Auditors also reviewed the Financial Statements as at 31 December 2013 and carried out an independent follow-up audit of the ESM and an independent audit of ESM Risk Management. The Board of Auditors draws up an annual report to the Board of Governors which is made accessible to the national parliaments and the supreme audit institutions of ESM Members, as well as to the European Court of Auditors and the European Parliament.

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 2013, as part of the maturing of the institution, the ESM Internal Risk Committee and Board Risk Committee considered the existing internal control standards with a view of adopting a best practice framework. The implementation of the principles of the Basel Committee's Framework for Internal Control Systems in Banking Organisations (1998) was agreed and the ESM achieved significant progress in the implementation of both entity level and process level controls.

Entity level controls have been addressed through the ESM corporate governance structure, internal policies and risk management activities. Specific control activities at process level have also been established, including:

- Top level reviews, four eyes checks, segregation of duties, activity controls, monitoring of compliance with exposure limits, formal rules requiring approval and authorisation of transactions over certain limits, verifications and reconciliations.
- Availability of internal financial, operational and compliance data as well as external market information that is relevant to decision making.
- Reliable information systems, which cover all significant activities of the organisation. These systems are robustly configured, continually monitored on an independent basis and supported by adequate contingency arrangements.
- Any internal control deficiencies identified by business lines or internal audit are reported in a timely manner to the appropriate management level and addressed promptly. Escalation levels are in place to ensure that material internal control deficiencies are reported to the Board of Directors via the Board Risk Committee.



Marcel Mosch

IT Officer

Joined the ESM in January 2013

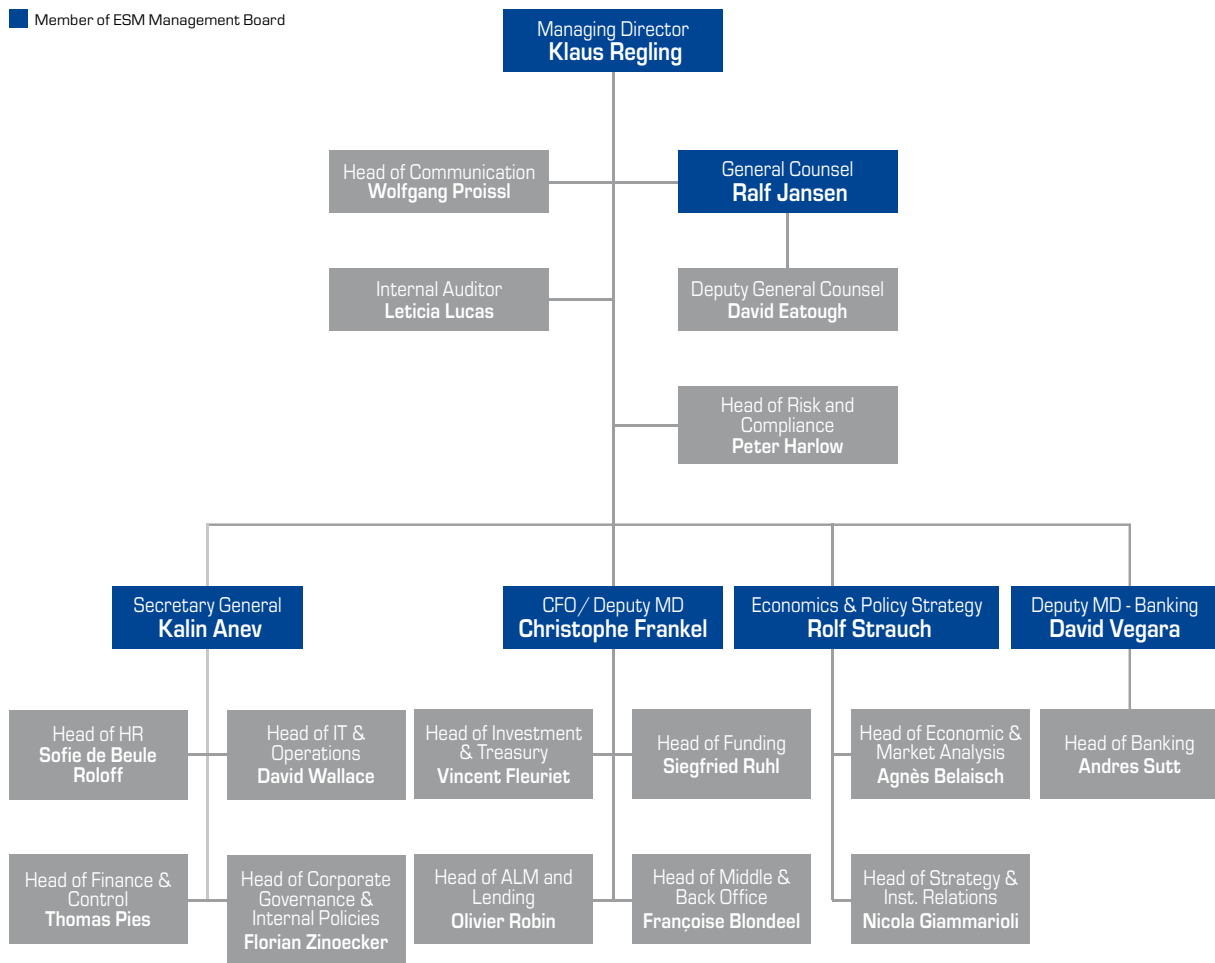
Worked in information technology with a focus on human-computer interaction at KPN Consulting, as a consultant for Cisco Systems and at ING Investment Management.

The ESM is a great workplace. In my role I'm trying to create the best user experience possible with state of the art technology. To do that for such diverse and enthusiastic colleagues is inspiring.

Organisation

ESM Organisational Structure (as of 31/12/2013)

■ Member of ESM Management Board



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 (e.g. interest rate, liquidity) and performs the cash management function for the institution. The department also ensures that all ESM financial transactions are being adequately booked, settled, controlled and reported and plays a front-end role in monitoring risks, including counterparty, settlement and operational. In addition, the department manages the paid-in capital and implements ESM Investment Policy.

Banking

The Banking department plays a key role in preparing the institution for the implementation of the direct recapitalisation instrument after the 2013 Eurogroup agreement on the main features of such instrument. It also participates, where appropriate, in the design and implementation of banking-related aspects of financial assistance where such assistance is used to support financial institutions, and contributes to the evolving debate on the banking union.

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 early warning systems on macroeconomic and credit risks in programme countries, develops and maintains credit risk assessment for ESM investment strategy, and represents/coordinates the ESM's activity with euro area 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 aspects/matters, provides transaction support, and is involved in the approval/review of new products.

Secretary General

The Secretary General 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 & Internal Policies provides the secretariat to ESM governance bodies and develops internal policies, internal control framework, procurement, project management and business continuity. IT & Operations provides information technology services, infrastructure and facilities. Finance & Control develops and maintains the accounting policies, prepares reports and accounts, monitors and reports on the financial position and maintains effective controls. Human Resources ensures that the ESM is able to attract and retain 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 ESM Managing Director and has its objectives set in the ESM Internal Audit Charter.

Communication and Press

The task of the Communication and Press department is to explain 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, interviews, speeches, press conferences and other public appearances by the Managing Director and the other members of the Management Board, social media, publications and visitor groups. In coordination with the other institutions of the euro area and its Member States, the department seeks to help shape a common political and economic narrative for the entire currency union.

Risk and Compliance

The Risk function is responsible for acting as a central independent risk oversight function of the ESM, developing and maintaining a regular inventory of risks, identifying, assessing and proposing mitigating alternatives, reporting risks in a consistent manner to ESM management and 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 mission of the ESM in a manner that stands up to the closest public scrutiny, by implementing a compliance framework which upholds sound and responsible business practices. The Head of Risk and Compliance, reporting to the Managing Director and chairing the Internal Risk Committee, is the Chief Risk Officer.

Human resources

On 31 December 2013, the ESM had 110 staff members. The ESM Board of Directors approved a growth of up to 165 staff members in 2014. The increase in headcount supports the ongoing maturing of the organisation. The ESM staff consists of managerial, operational and support staff with backgrounds in both the public and private sectors. Currently, around three-quarters of staff are employed on fixed-term contracts ranging from 2 to 5 years in length. In principle, all staff starts on a fixed-term contract. Upon renewal indefinite contracts may be offered to staff currently employed under fixed term contracts, in line with applicable rules. Additionally, non-core functions are outsourced to external public and private institutions through service level agreements and other contractual arrangements.



Tim Eckermann

**Human Resources
Senior Officer**

Joined the ESM in September 2012

Employed by the World Bank Group, currently on secondment to the ESM.

My role involves developing HR initiatives so the ESM attracts, retains and develops great people so that the institution can best meet its mandate. We strive to develop an interesting and attractive work environment, applying relevant HR practices that meet the ESM's current and future needs.

Recruitment policy

The decision to recruit is taken by the Management Board within the overall staff limit set by the Board of Directors. When evaluating candidates, the ESM takes every step necessary to ensure fair competition based on merits and experience of applicants. Additionally, the ESM aims to achieve a diverse workforce and ensure equal treatment: that is, not to discriminate on the grounds of age, culture, ethnic and racial background, family status, gender, nationality, physical ability, religion or sexual orientation; however, the crucial hiring criteria are individual merit, experience and fit with the position. Lastly, the ESM introduced a traineeship programme, designed to broaden the profile of staff and provide students with the opportunity to contribute to the institution and learn from its staff.

Diversity

The ESM recognises that a strong commitment to diversity and inclusion is not simply good for business, but is also essential to business success as reflected in the institution's core values, including: teamwork, respect and creativity.

The ESM employed 30 nationalities at the end of 2013. The organisation recruits staff across the globe and is not limited to nationals of ESM Members. Of all staff, 77% come from ESM Members, 15% from the remaining EU Member States and 8% from the rest of the world (Switzerland, Australia, Canada, China, United States, Brazil, New Zealand and India).

The age distribution ranges from 26 to 64 years old, with the following split: 14% 20–30 years, 46% 31–40 years, 29% 41–50 years, 9% 51–60–years, and 2% above 60 years. To attract young professionals, the ESM has built relationships with leading universities around the globe, further extending the organisation's reach as an employer to different age groups. At the same time, the ESM is also attracting staff aged above 50 years, which is a challenging age for career change.

The gender split is currently 68% male and 32% female. The ESM Management Board is committed to achieve better gender balance. The organisation has analysed some of the challenges (lack of depth of the local employment market for dual careers, more male graduates and candidates in financial services, contractual arrangements and relocation of families) and is trying to mitigate these by providing support to moving spouses, actively encouraging more women to apply, flexible working arrangements (such as teleworking and part-time working), diversity working groups and training of management.

The ESM believes that these efforts will further diversify its staffing profile and bring it closer to the goal of a more rounded and balanced staff.

Secondment/fellowship programme

The ESM requested submissions from peer organisations and leading corporations in order to recruit highly motivated and skilled individuals to be seconded to the ESM for a period of two years, with an option to extend for an additional year. Expertise in finance, economics, law and corporate functions were the key areas of focus for the secondment programme.

The ESM also opened a number of positions through the Fellowship programme, inviting various institutions/corporations to submit secondees candidates.

Staff learning and development

The ESM places pronounced value on technical and professional skills development to ensure that members of staff are equipped with the required competencies to deal with current and future challenges faced by the ESM. In 2013, the ESM offered a variety of learning and development courses for staff, based on their individual motivation and requirements, and the organisation's overall needs.

Box 10. ESM Administrative Tribunal

On 29 October 2013, the Board of Directors established the Administrative Tribunal of the European Stability Mechanism (ESMAT) and adopted its Statute. The ESMAT is an independent body which hears and passes judgment on staff employment matters within its competence as defined by its Statute.

The establishment of the ESMAT corresponds to the need to give effect to the human right of access to justice for ESM members of staff with regards to their employment conditions. Given that the ESM members of staff currently do not have access to the jurisdiction of the Court of Justice of the European Union as the ESM is a separate legal entity under Public International Law, it was necessary for the ESM to establish its own Administrative Tribunal. Further, the design of the ESMAT complies with the principle of good administration and cost effectiveness, as the costs related to the ESMAT will be proportionate to the number of cases to be dealt with.

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 a first term of four years.

On 24 March 2014 the Board of Directors took note the appointment as members of the ESMAT of:

Julian Currall, for a term of 5 years; Celia Goldman, for a term of 5 years; Virginia Melgar, for a term of 4 years; Haris Tagaras, for a term of 4 years; and Gerhard Ullrich, for a term of 5 years.

The ESMAT inaugural meeting took place on 10 March 2014. During the meeting, Virginia Melgar was elected as President and Haris Tagaras as Vice-President.

Chapter

4

ESM Financial Report

2013 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 Members which are experiencing, or are threatened by severe financial problems. On this basis, the ESM is 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 in respect of its financial result.

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

Balance sheet

At year-end, the increase in the total assets was due to the rise in the lending volume and the start of the ESM's own funding programme. In this regard, the ESM contributed to the new financial assistance programme for Cyprus with disbursements of €4.6 billion and disbursed additional €1.9 billion to Spain in 2013.

To provide financial assistance to ESM Members, the ESM relies on its funding activity. In 2013 the total liability in respect of debts evidenced by certificates issued by the ESM increased by 52.2% to €60.0 billion.

In 2013 the shareholders contributed additional tranches of paid-in capital totalling €31.4 billion. At year-end these were invested in ESM assets in the form of cash and equivalents, deposits with central banks, and debt securities including fixed-income securities.



Leticia Lucas

Internal Auditor

Joined the ESM in July 2013

Worked previously at PricewaterhouseCoopers, Allianz Global Investors AG and Equens SE.

It is gratifying to think that you are somehow contributing to shape the future of Europe. The ESM's multicultural environment, team-work orientation, dynamic and friendly working atmosphere are also important motivation factors for me.

Part of the proceeds of short term funding instruments issued by the ESM was invested in short term instruments issued by the EFSF. The Transitional Investment Portfolio ("TIP") addresses 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. The TIP can have a maximum aggregate principal amount outstanding of €25.0 billion and will expire at the end of 2014. As at 31 December 2013, the TIP had a value of €9.1 billion (there were no TIP investments as at 31 December 2012).

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 at 31 December 2013, an unrealised valuation loss of €115.7 million was recorded. This compares with an unrealised gain of €19.5 million at the end of 2012. The negative unrealised valuation result was mainly a consequence of a general increase in yields towards year-end, which in turn led to a decrease in market values for the existing ESM portfolio. Due to the very conservative investment strategy of the ESM, the variation of the fair value is expected to be limited and the realisation of a loss at maturity or at the time of sale of an investment is highly unlikely.

Profit and loss account

For the financial year 2013, which was the first full year of operation, the ESM recorded a positive net result of €253.9 million, compared with a loss of €0.5 million for the previous period, which was the year of inauguration of the ESM with only 3 months of activity.

The ESM recorded an interest income of €352.8 million for 2013. In parallel, the interest charges in relation to the funding activities amounted to €110.7 million.

In addition to interest income on loans, the investment income made from the paid-in capital contributed significantly to the result of the ESM. Due to the additional tranches of paid-in capital of €31.4 billion in 2013, the ESM recognised an interest income of €81.6 million, compared with €3.8 million in 2012.

The operating costs, which include general administrative expenses and depreciation of fixed assets, increased mainly due to the transfer of staff from the EFSF to the ESM and the fact that 2013 was the ESM's first full year of operation. As the ESM provides administrative services to the EFSF, €17.0 million of the operating costs were charged to the EFSF and were recognised as other operating income. The ESM continues to focus on budgetary discipline and effective cost control.

Outlook for 2014

As of 30 April 2014, the ESM has a paid-in capital of €80 billion. The investment of the full paid-in capital will be reflected in the investment portfolio. To support its financial assistance programmes in 2014, the ESM has a funding target of €17 billion. The ESM expects its net realised results to remain relatively stable.

Financial Statements

31 December 2013

Contents

Balance sheet	63
Off-balance sheet	63
Profit and Loss account	64
Statement of changes in equity	65
Statement of cash flows	66
Notes to the Financial Statements	67

BALANCE SHEET

As at 31 December 2013

(in €'000)

	Notes	31.12.2013	31.12.2012
ASSETS			
Cash in hand, balances with central banks and post office banks	5	4,968,640	7,675,815
Loans and advances to credit institutions	6		
(a) other loans and advances		22,976,514	16,501,514
		22,976,514	16,501,514
Loans and advances to euro area Member States	7	45,933,000	39,461,824
Debt securities including fixed-income securities	8		
(a) issued by public bodies		45,190,785	8,429,948
(b) issued by other borrowers		5,170,990	366,086
		50,361,775	8,796,034
Intangible assets	9	128	101
Tangible assets	10	2,944	3,050
Subscribed capital unpaid	2.13/15	620,000,000	620,000,000
Subscribed capital called but not paid	2.13/15	15,712,416	47,137,248
Prepayments and accrued income	11	460,654	123,909
Total assets		760,416,071	739,699,495
LIABILITIES			
Debts evidenced by certificates	12		
(a) debt securities in issue		60,026,441	39,461,824
		60,026,441	39,461,824
Other liabilities	13	22,831	18,867
Accruals and deferred income	14	229,112	199,754
Total liabilities		60,278,384	39,680,445
SHAREHOLDERS' EQUITY			
Subscribed capital	2.13/15	700,000,000	700,000,000
Fair value reserve	8	(115,716)	19,548
Profit/loss brought forward		(498)	-
Profit/loss for the financial year/period		253,901	(498)
Total shareholders' equity		700,137,687	700,019,050
Total equity and liabilities		760,416,071	739,699,495

The accompanying notes form an integral part of these Financial Statements.

OFF-BALANCE SHEET

As at 31 December 2013

(in €'000)

	Notes	31.12.2013	31.12.2012
OFF-BALANCE SHEET			
Commitments	22		
(a) undisbursed loans to euro area Member States		4,368,000	60,532,000
		4,368,000	60,532,000

The accompanying notes form an integral part of these Financial Statements.

PROFIT AND LOSS ACCOUNT

For the financial year ending 31 December 2013

(in €'000)

	Notes	Year from 1 January 2013 to 31 December 2013	Period from 8 October 2012 to 31 December 2012
Interest receivable and similar income			
(a) on loans and advances to credit institutions		13,245	471
(b) on loans and advances to euro area Member States	16	268,979	12,649
(c) on debt securities including fixed-income securities		70,600	3,369
		352,824	16,489
Interest payable and similar charges			
(a) on debts issued		(110,680)	(4,417)
		(110,680)	(4,417)
Commissions receivable		105	258
Commissions payable		(109)	(289)
Other operating income	17	17,010	-
Net profit on financial operations		26,093	1,282
General administrative expenses			
(a) staff costs	18	(13,965)	(217)
- wages and salaries		(10,292)	(123)
- social security		(3,673)	(94)
<i>of which relating to pension</i>		(3,196)	(91)
(b) other administrative expenses	19	(16,876)	(13,558)
		(30,841)	(13,775)
Value adjustments in respect of intangible and tangible assets		(501)	(46)
Profit/loss for the financial year/period		253,901	(498)

The accompanying notes form an integral part of these Financial Statements.

STATEMENT OF CHANGES IN EQUITY

For the financial year ending 31 December 2013

(in €'000)

	Subscribed capital	Fair value reserve	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	Profit/loss brought forward	Profit/loss for the financial period	Total
At 8 October 2012	-	-	-	-	-
Subscription of capital	700,000,000	-	-	-	700,000,000
Loss for the financial period	-	-	-	(498)	(498)
Fair value reserve	-	19,548	-	-	19,548
At 31 December 2012	700,000,000	19,548	-	(498)	700,019,050

The accompanying notes form an integral part of these Financial Statements.

STATEMENT OF CASH FLOWS

For the financial year ending 31 December 2013

(in €'000)

	Year from 1 January to 31 December 2013	Period from 8 October 2012 to 31 December 2012
Cash flows from operating activities:		
Profit/loss for the financial year/period	253,901	(498)
<i>Adjustments for:</i>		
Value adjustments in respect of tangible and intangible assets	501	46
<i>Changes in:</i>		
Tangible and intangible assets	(422)	(3,197)
Accrued interest and interest received	(702,405)	(126,646)
Prepayments	(18,596)	(93)
Accruals and deferred income and interest paid	79,744	(1,544)
Other liabilities	3,964	18,867
Interest received	378,080	33,271
Up-front service fee received	32,325	197,340
Interest paid	(70,985)	-
Net cash provided by operating activities	(43,893)	117,546
Cash flows from investing activities		
Change in debt securities including fixed-income securities	(41,701,005)	(8,802,969)
Change in loans and advances to credit institutions	(6,475,000)	(16,501,514)
Loans disbursed during the year	(6,465,000)	-
Net cash used in investing activities	(54,641,005)	(25,304,483)
Cash flows from financing activities		
Payment of capital	31,424,832	32,862,752
Changes in debt securities in issue	20,552,891	-
Net cash provided by financing activities	51,977,723	32,862,752
Net increase/decrease in cash and cash equivalents	(2,707,175)	7,675,815
Cash and cash equivalents at the beginning of the financial year/period	7,675,815	-
Cash and cash equivalents at the end of the year/period	4,968,640	7,675,815

The accompanying notes form an integral part of these Financial Statements.

Notes to the Financial Statements

1. General information

The European Stability Mechanism ("ESM" or "the Entity") 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 Treaty establishing the ESM was originally signed by finance ministers of the 17 euro area countries on 11 July 2011. A modified version of the Treaty, incorporating amendments aimed at improving the effectiveness of the mechanism, 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 all 17 euro area Member States.

The present financial statements cover the period from 1 January 2013 to 31 December 2013. Comparative figures cover the period from the ESM's inauguration on 8 October 2012 until 31 December 2012, which should be considered when reading the financial statements.

On a proposal from the Managing Director, the Board of Directors adopted the Financial Statements on 24 March 2014 and authorised their submission to the Board of Governors for approval at their meeting on 19 June 2014.

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 governments of ESM Members.

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 and established in the ESM Pricing Policy:

- Base rate – the cost of funding incurred by the ESM, derived by a daily computation of the actual interests accrued on all of the 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:
 - i. up-front service fee (50 bps) generally deducted from the drawn amount;
 - ii. 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.
 - i. For loans granted, the margin is 10 bps;
 - ii. For primary market support facility, the margin is 10 bps;
 - iii. For secondary market support facility, the margin is 5 bps;
 - iv. For precautionary financial assistance granted, the margin is 35 bps;
 - v. For financial assistance provided to an ESM Member for the recapitalisation of its financial institutions, the margin is 30 bps.

A penalty interest may be applied on overdue amounts, which corresponds to a charge of 200 bps over the higher of the EURIBOR rate applicable to the relevant period selected by the ESM and the interest rate which would have been payable.

1.3. The ESM's financial assistance to Spain

On 20 July 2012, the Eurogroup (consisting of the finance ministers of countries whose currency is the euro) reached political agreement that financial assistance should be granted to Spain for the recapitalisation of its banking sector following an official request made by the Spanish government. The assistance mandated by the Eurogroup was designed to cover the estimated capital requirements along with an additional safety margin, amounting to € 100 billion. The loans were provided to the Fondo de Reestructuración Ordenado Bancaria (FROB), the bank recapitalisation fund of the Spanish government, and then channelled to the financial institutions concerned. The assistance was initially committed under a programme of the European Financial Stability Facility ("EFSF"). On 28 November 2012 the ESM Board of Governors decided, pursuant to Article 40(1) and (2) of the Treaty Establishing the European Stability Mechanism (the "Treaty"), that commitments of the EFSF to provide financial assistance to Spain will be assumed by the ESM.

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 the FROB on 11 December 2012. This marks the first instance of financial assistance provided by the ESM.

The FROB used these notes for the recapitalisation in the amount of € 37 billion of the following banks: BFABankia, Catalunya-Caixa, NCG Banco and Banco de Valencia. Additionally the FROB provided € 2.5 billion to SAREB, the asset management company for assets arising from bank restructuring.

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

On 31 December 2013, the ESM financial assistance programme expired. The ESM disbursed a total of € 41.3 billion to the Spanish government for the recapitalisation of the banking sector. The remaining undisbursed amount of the facility was cancelled.

This was the first financial assistance programme carried out by the ESM. Also it was the first time the instrument of recapitalising banks through loans granted to a government was used. There were no contributions from other lenders.

1.4. The ESM's financial assistance to Cyprus

On 25 June 2012 the Cypriot Government submitted a request for stability support to the President of the Eurogroup. The key elements for a macroeconomic adjustment programme were agreed by the Eurogroup on 25 March 2013.

The agreement on the macroeconomic adjustment programme opened the way for members of the euro area to decide on a package of financial assistance for Cyprus 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 € 9 billion, and the International Monetary Fund (IMF) contributes 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 disbursement of € 2 billion was transferred on 13 May 2013, and the second disbursement of € 1 billion was transferred on 26 June 2013. The second tranche of assistance, in the form of € 1.5 billion of ESM floating rate notes, was disbursed on 27 September 2013. The Cypriot government will use the notes for the recapitalisation of the cooperative banking sector. Subsequently the third tranche of assistance of € 0.1 billion was disbursed in cash on 19 December 2013.

The financial assistance facility is designed to cover Cyprus's financing needs after the inclusion of proceeds from burden-sharing measures adopted by the Cypriot government. These needs include budgetary financing, the redemption of medium and long-term debt, and the recapitalisation of financial institutions with the exception of the country's two largest banks (Bank of Cyprus and Cyprus Popular Bank, which were subject to restructuring and resolution measures by the Cypriot government).

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 Entity is described in the subsequent Notes. The Directive 2006/46/EC has been amended by Directive 2013/34/EU. The ESM applies the same transitional period applicable to the Member States for transposition by 2016.

The Entity prepares an Activity Report ("description of policies and activities") which 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 management¹ to exercise its judgment in the process of applying the Entity's accounting policies. Areas involving a higher degree of judgment or complexity, or areas where assumptions and estimations 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 the paid-in capital and reserve fund investments which are measured at fair value with gains and losses being recognised in the fair value reserve.

¹ 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.

2.3. Use of estimates

In preparing the Financial Statements, the management is required to make estimates and assumptions that affect reported income, expenses, assets, liabilities and disclosure of contingent assets and liabilities. 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.

As described in the Note 1.2 concerning the overview of the pricing structure of the financial assistance programmes, the ESM is entitled to charge 50 bps of up-front service and 0.5 bps annual service fee to cover the ESM's operational cost. The ESM recognises the up-front service fees over a seven year period, to reflect to the best the economy of the business and to match to the best the occurrences of the expenses aimed 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 in light of the ESM's purpose as being a permanent crisis resolution mechanism aiming to accompany beneficiary Member States to 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 has been required as at 31 December 2013 and 2012, and thus none has been recognised.

2.4. Foreign currency translation

The ESM uses the euro (€), the single currency of the Member States participating in the third stage of Economic and Monetary Union, 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 accordingly revalued in 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

With a view to clarifying management of its financial assets, the ESM has established the following portfolio categories:

2.6.1. Paid-in capital and reserve fund investments

The provisions on the capital of the ESM are laid down in Chapter 3 of the ESM Treaty. The initial aggregate nominal value of paid-in shares is € 80 billion. Moreover in accordance with Chapter 5 of the ESM Treaty, 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.

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 on 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 has the main objective of ensuring the financial strength of the ESM. This tranche is managed to enhance the return of the Investment Portfolios subject to the constraints specified in the Investment objectives as well as the asset eligibility criteria. This tranche is also mainly invested in liquid investment instruments, and could also be 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 being 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 being 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. However, interest is recognised on a straight line basis.

2.6.2. Liquidity buffer investments

The ESM's borrowing strategy has to pursue several objectives and principles to comply with the purpose established in Article 3 of the Treaty. First, the market environment under which the ESM operates is volatile. The general borrowing strategy must therefore offer the possibility to react rapidly to unexpected market developments, including through the building up of liquidity buffers during episodes of systemic risk, and ensure market access even in a difficult market environment with a high degree of uncertainty.

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

2.6.3. Transitional Investment Portfolio

The transitional investment portfolio comprises short term notes issued by the EFSF. The aim of this purchase is to provide intermediate short term financing to the EFSF due to the transfer of the bill programme from the EFSF to ESM. This portfolio will allow the EFSF to roll the short term funding of the former EFSF bill programme into long term funding. The portfolio is of temporary nature and will expire at the end of 2014.

The securities of this portfolio are initially recognised at fair value including any transaction costs, and measured subsequently at fair value with gains and losses being 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.

2.6.4. Determination of fair value

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

A financial instrument is regarded as traded 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 incorporate factors that market participants would take into account in pricing a transaction.

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 is also included in Interest receivable and similar income in the profit and loss account.

Specific value adjustments are presenting risks of non-recovery of 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 in 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. Intangible assets comprise computer software that are amortised within 3 years.

2.9. Tangible assets

Tangible assets are recorded in 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: 9 years or until the end of building rent period
- Furniture and office equipment: 5 years
- IT equipment: 3 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 or not exclusively related to the reporting period together with any income which, though relating to the financial year in question, but will be received only 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 for which the nature 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 a number of 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 2013 the ESM's shareholders are the 17 euro area Member States. In accordance with Article 8 of the ESM Treaty, the initial authorised capital is € 700 billion, which is divided into seven million shares, having 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 billion.

In accordance with Article 4 of the Directive 86/635/EEC as amended, the initial authorised capital stock of € 700 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 which are not or not exclusively related to the reporting period, together with any charges which, though relating to the financial year in question, will be paid only in the course of a subsequent financial year.

2.15. Interest receivable and payable

Interest income and expense 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 'Accruals and deferred income' under liabilities.

2.16. Employee benefits

(a) Pension obligation

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

With effect of 1 May 2013, the ESM has discontinued the previous arrangements described and has set up a pension plan with defined contribution characteristics funded through payments to an external insurance service provider. This scheme also covers the risk of death and disability via insurance agreements.

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

(b) Termination benefits

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

Such termination benefits could not be reliably estimated. As further described in Note 18, therefore no provision is recognised as at 31 December 2013.

2.17. Taxation

By Article 36 of the ESM Treaty, within the scope of its official activities, the ESM, its assets, income, property and its operations and transactions authorised by the ESM Treaty, shall be exempt from all direct taxes. ESM Members have agreed to remit or refund all indirect taxation, subject to certain exceptions, by virtue of 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
- 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 High Level Principles for Risk Management of the ESM the targeted risk appetite shall 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 head of the Risk Department ("Head of Risk") is a direct report to the Managing Director. The Head of Risk is responsible and accountable for informing the Managing Director on all risks to ensure enforcement and oversight. The Managing Director, as Chairman of the Board of Directors, reports the enforcement and oversight 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 has been created. The Internal Risk Committee translates the risk appetite into the internal limit structure, which is described in the Risk Policy approved by the Board of Directors. The Internal Risk Committee 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 Internal Risk Committee will conduct on a periodical basis a risk self-assessment and reports the result to the Managing Director. It has authority to suggest to the Managing Director to undertake investigations on risk management (including outsourced activities) through either internal or external audit teams.

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 investment of paid-in capital, placement of possible excess liquidity, and hedging operations. Issuer risk is also a particular form of credit risk which 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 Risk function of the ESM. 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, the exposures set out hereafter are based on net carrying amounts as reported in the balance sheet.

In €'000	Maximum exposure 31.12.2013	Maximum exposure 31.12.2012
Cash in hand, balances with central banks and post office banks	4,968,640	7,675,815
Loans and advances to credit institutions	22,976,514	16,501,514
Debt securities including fixed-income securities	50,361,775	8,796,034
On balance sheet credit risk exposure	78,306,929	32,973,363
Off balance sheet items	-	-
Maximum credit risk exposure	78,306,929	32,973,363

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.

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.

In €'000	Credit rating*	Clean carrying value as at 31.12.2012
Cash in hand, balances with central banks and post office banks	not rated**	7,675,557
	AA+	258
Loans and advances to credit institutions	not rated**	16,500,000
	AA+	1,514
Debt securities including fixed-income securities	AAA	6,256,136
	AA+	2,539,898
Total		32,973,363

* 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. In the financial statements of 2012 the rating of the country was considered, therefore comparatives have been amended to align the presentation.

This table does 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.

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. In order 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 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 potential for loss arising from adverse movements in interest rates. 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 swap and forward rate agreements.

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 the paid-in capital investments are denominated in euro. The Entity 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 inability to raise money in a timely manner. Due to this, 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 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 table hereafter analyses the financial assets and liabilities and the shareholders' equity of the Entity by maturity on the basis of the period remaining between the balance sheet date and the contractual maturity date.

As at 31 December 2013 in €'000	Less than three 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)
As at 31 December 2012 in €'000					
	Less than three 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	7,675,815	-	-	-	7,675,815
Loans and advances to credit institutions	13,650,000	2,850,000	-	1,514	16,501,514
Loans and advances to euro area Member States	-	-	-	39,461,824	39,461,824
Debt securities including fixed-income securities	3,037	753,934	8,039,063	-	8,796,034
Prepayments and accrued income	123,909	-	-	-	123,909
Total financial assets	21,452,761	3,603,934	8,039,063	39,463,338	72,559,096
LIABILITIES					
Debt securities in issue	2,499,942	6,461,882	30,500,000	-	39,461,824
Other liabilities	18,867	-	-	-	18,867
Accruals and deferred income	199,754	-	-	-	199,754
Total financial liabilities	2,718,563	6,461,882	30,500,000	-	39,680,445
Shareholders' equity*	-	-	-	32,881,802	32,881,802
Total shareholders' equity**				32,881,802	32,881,802
Net of financial position	18,734,198	(2,857,948)	(22,460,937)	6,581,536	(3,151)

* 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 2013.

All departments are responsible for proactive mitigation of operational risks and for the robustness of the controls in their processes. In case 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 in order to ensure 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 the operational risk events and implement improvements in the underlying processes and controls in order to reduce the probability of re-occurrence. This approach is complemented with an annual self-assessment of the top operational risks of the Entity (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 applies elements of its High Level Principles for Risk Management, as defined by the Board of Directors and its Risk Policy to the provision of financial support to ESM Members to the extent that they do not cover counterparty risk when extending financial assistance to beneficiary euro area Member States. As such, financial assistance in line with the purpose of the ESM is granted 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. Therefore, the assistance aims to provide financial support according to rules that differ from those of financial

markets, meaning the overall aim is to accompany the beneficiary Member State to a 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 ECB and whenever possible the IMF, addresses and mitigates credit risk. Moreover, it is the mutual understanding of the ESM Members that ESM loans enjoy preferred creditor status in a similar fashion to those of the IMF, while accepting preferred creditor status of the IMF over the ESM. This does, however, not apply to financial assistance in the form of ESM loans following a European financial assistance programme existing at the time of the signature of the ESM Treaty (as at 31 December 2013 this applies to the financial assistance granted to Spain). Moreover, 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 has provided financial assistance to Spain for the recapitalisation of its financial sector (which, by the terms of the relevant loans must be repaid by 2027), and is providing financial assistance to Cyprus, which is implementing a macroeconomic adjustment programme. A breakdown of all disbursed amounts as well as the movements during the period is provided in Note 7.

From an investor's point of view, the capital structure and the capital calls address the risk arising from the non-payment of the beneficiary Member States and potential losses from other risks. In accordance with 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:

- i. 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 which 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. If any ESM member fails to meet the required capital call, one or more revised increased capital calls would be made to all ESM Members by increasing the contribution rate of the remaining ESM Members on a pro-rata basis. When the ESM Member which failed to contribute settles its debt to the ESM, the excess capital is returned to the other ESM Members.

- ii. An emergency capital call under Article 9(3) of the ESM Treaty 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 such 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. However, if any ESM Member fails to meet the required capital call, the same procedure would apply as for capital calls to replenish paid-in capital.

This mechanism provides the strongest possible assurance to ESM debt securities that they 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:

	31.12.2013	31.12.2012
Current account balances with central banks	4,966,086	7,675,557
Current account balances with other banks	2,554	258
Total cash in hand, balances with central banks and post office banks	4,968,640	7,675,815

6. Loans and advances to credit institutions (in €'000)

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

	31.12.2013	31.12.2012
Money market deposits	22,975,000	16,500,000
Other deposits	1,514	1,514
Total cash	22,976,514	16,501,514

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

Other deposits entirely consist 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 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

	Nr. of loans	Nominal amount	Clean carrying value as at 31 December 2012
Loans to euro area Member States			
- to Spain	5	39,468,000	39,461,824
Total	5	39,468,000	39,461,824

The following table shows the movements of the loans to euro area Member States during the period:

Balance as at 8 October 2012	-
New disbursements	39,461,366
- to Spain	39,461,366
Premiums/discounts amortisation	458
Balance as at 31 December 2012	39,461,824
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 amortisation	6,176
Balance as at 31 December 2013	45,933,000

8. Debt securities including fixed-income securities (in €'000)

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

	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

The following table shows the details of the debt securities valuation and their classification as at 31 December 2012:

	Clean amortised cost	Unrealised gains	Clean fair (carrying) value	Nominal amount
Paid-in capital portfolio	8,776,486	19,548	8,796,034	8,336,935
Total	8,776,486	19,548	8,796,034	8,336,935

As at 31 December 2013, the clean amortised cost of the debt securities is €'000 50,477,491 (31 December 2012: €'000 8,776,486), against a clean market value of €'000 50,361,775 (31 December 2012: €'000 8,796,034). 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 which sets strict investment guidelines that focus on issuers with highest credit standing in euro and included a limit structure to mitigate the maximum exposure per counterparty. Regarding the transitional investment portfolio we refer to Note 2.6.3.

All debt securities including fixed income securities of the paid-in capital investments are listed on regulated markets and the fair values of all these assets are determined based on quoted market prices.

9. Intangible assets (in €'000)

The following table shows the movements of the intangible assets during 2013:

	Software	Total intangible assets
Historical cost		
Balance as at 1 January 2013	107	107
Additions	79	79
Balance as at 31 December 2013	186	186
Accumulated depreciation		
Balance as at 1 January 2013	(6)	(6)
Depreciation	(52)	(52)
Balance as at 31 December 2013	(58)	(58)
Net book value		
Balance as at 31 December 2013	128	128
Balance as at 31 December 2012	101	101

10. Tangible assets (in €'000)

The following table shows the movements of the tangible assets during 2013:

	Fixtures and fittings	Furniture and office equipments	Total tangible assets
Historical cost			
Balance as at 1 January 2013	2,025	1,065	3,090
Additions	192	150	342
Balance as at 31 December 2013	2,217	1,215	3,432
Accumulated depreciation			
Balance as at 1 January 2013	(18)	(22)	(40)
Depreciation	(230)	(218)	(448)
Balance as at 31 December 2013	(248)	(240)	(488)
Net book value			
Balance as at 31 December 2013	1,969	975	2,944
Balance as at 31 December 2012	2,007	1,043	3,050

11. Prepayments and accrued income (in €'000)

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

	31.12.2013	31.12.2012
Interest receivable on:		
- Debt securities including fixed-income securities	404,035	112,700
- Loans and advances to euro area Member States	31,732	10,646
- Loans and advances to credit institutions	6,199	471
Amounts charged to EFSF for administrative services (Note 17)	17,009	-
Commitment fee receivable	1,184	-
Prepayments	495	92
Total prepayments and accrued income	460,654	123,909

12. Debts evidenced by certificates (in €'000)

The table below 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 bp
Spain	EU000A1U98X6	1,865,000	05/02/2013	05/08/2015	6M Euribor - 15 bp
Spain	EU000A1U98U2	6,500,000	11/12/2012	11/06/2014	6M Euribor - 12 bp
Spain	EU000A1U98V0	12,000,000	11/12/2012	11/12/2014	6M Euribor - 12 bp
Spain	EU000A1U98W8	12,000,000	11/12/2012	11/12/2015	6M Euribor - 6 bp
Long-term funding	EU000A1U98O3	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	EU000A1U97Z0	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	EU000A1U97O4	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 table below discloses the details of debt securities in issue outstanding as at 31 December 2012, together with the coupon rates and due dates.

Financial assistance programme	ISIN code	Nominal amount	Issue date	Maturity date	Coupon
Spain	EU000A1U97C2	2,500,000	11/12/2012	11/02/2013	N/A*
Spain	EU000A1U97D0	6,468,000	11/12/2012	11/10/2013	N/A*
Spain	EU000A1U98U2	6,500,000	11/12/2012	11/06/2014	6M Euribor - 12 bp
Spain	EU000A1U98V0	12,000,000	11/12/2012	11/12/2014	6M Euribor - 12 bp
Spain	EU000A1U98W8	12,000,000	11/12/2012	11/12/2015	6M Euribor - 6 bp
Total		39,468,000			

* Zero-coupon bond

The following table shows the movements of the debt securities in issue during 2013 and 2012:

	2012
Balance as at 8 October 2012	-
Issuance during the period	39,461,366
Premiums/discounts amortisation	458
Balance as at 31 December 2012	39,461,824
	2013
Balance as at 1 January 2013	39,461,824
Issuance during the year	63,400,091
Maturities during the year	(42,847,200)
Premiums/discounts amortisation	11,726
Balance as at 31 December 2013	60,026,441

All debt securities in issue as at 31 December 2012 and 31 December 2013 are issued under English law as the governing law.

13. Other liabilities (in €000)

As at 31 December 2013, the other liabilities are entirely composed of supplier's invoices which are not yet settled amounting to €'000 22,831 (31 December 2012: €'000 18,867), from which €'000 14,806 (31 December 2012: €'000 16,040) is against EFSF.

14. Accruals and deferred income (in €'000)

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

	31.12.2013	31.12.2012
Interest payable on debts evidenced by certificates	31,928	3,958
Deferred income on up-front service fee	197,184	195,796
Total accruals and deferred income	229,112	199,754

As explained in 2.3.1., 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	Uncalled capital	Subscribed, called capital
At 8 October 2012			
Subscription to the authorised capital	700,000,000	- 700,000,000	-
Authorised capital calls	-	80,000,000	80,000,000
At 31 December 2012	700,000,000	- 620,000,000	80,000,000
	Subscribed capital	Uncalled capital	Subscribed, called capital
At 1 January 2013	700,000,000	- 620,000,000	80,000,000
Subscription to the authorised capital	-	- 700,000,000	-
Authorised capital calls	-	80,000,000	80,000,000
At 31 December 2013	700,000,000	- 620,000,000	80,000,000

As of 31 December 2013 the ESM's shareholders were the 17 euro area Member States. Subsequently on 13 March 2014 they have been joined by Latvia. 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 European Central Bank's (ECB) capital. This contribution key will be also updated as a result of Latvia joining the ESM. The authorised capital is € 700 billion, divided into 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, € 620 billion is uncalled. As at 31 December 2013, the called subscribed capital amounts to € 80 billion, out of which € 64.3 billion is paid.

ESM Members as of 31 December 2013	ESM Key (%)	Number of shares	Subscribed capital (in €'000)	Subscribed capital called and paid (in €'000)
Federal Republic of Germany	27.1464	1,900,248	190,024,800	17,373,696
French Republic	20.3859	1,427,013	142,701,300	13,046,976
Italian Republic	17.9137	1,253,959	125,395,900	11,464,768
Kingdom of Spain	11.9037	833,259	83,325,900	7,618,368
Kingdom of the Netherlands	5.7170	400,190	40,019,000	3,658,880
Kingdom of Belgium	3.4771	243,397	24,339,700	2,225,344
Hellenic Republic	2.8167	197,169	19,716,900	1,802,688
Republic of Austria	2.7834	194,838	19,483,800	1,781,376
Portuguese Republic	2.5092	175,644	17,564,400	1,605,888
Republic of Finland	1.7974	125,818	12,581,800	1,437,920
Ireland	1.5922	111,454	11,145,400	1,019,008
Slovak Republic	0.8240	57,680	5,768,000	527,360
Republic of Slovenia	0.4276	29,932	2,993,200	273,664
Grand Duchy of Luxembourg	0.2504	17,528	1,752,800	160,256
Republic of Cyprus	0.1962	13,734	1,373,400	125,568
Republic of Estonia	0.1860	13,020	1,302,000	119,040
Malta	0.0731	5,117	511,700	46,784
Total	100.00	7,000,000	700,000,000	64,287,584

As at 31 December 2013 the subscribed capital called but not paid amounts to €'000 15,712,416 (31 December 2012: €'000 47,137,248).

In accordance with Article 9 of the ESM Treaty, there are three different instances when a capital call can be made. A general capital call concerns payment of the initial capital and an increase of paid-in capital which 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, with mutual agreement, may call in authorised capital at any time.

Moreover as described in Note 4, a capital call to replenish paid-in capital could happen 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 which 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.

Finally, an emergency capital call 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.

16. Interest receivable and similar income on loans and advances to euro area Member States

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

	2013	2012
Interest on loans (*)	236,859	11,105
Amortisation up-front service fee	30,936	1,544
Commitment fee	1,184	-
Total interest and similar income	268,979	12,649

(*) 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.

17. Other operating income

The EFSF has asked the ESM to provide certain administrative services and other support services in order to assist EFSF in performing its activities. To formalise such cooperation ESM and EFSF entered into a Service Level Agreement with the commencement date of 1 January 2013.

Under the terms of the Agreement, the ESM is entitled to charge Service Fees to EFSF which are calculated with the objective to achieve a fair cost-sharing between ESM and EFSF. For the services provided during the financial year 2013, the ESM charged € 17.0 million to EFSF. The amount comprises staff costs (€ 8.4 million) and other administrative expenses (€ 8.6 million). The amount has not been paid yet at balance sheet date (refer to Note 11).

18. Staff costs

The transfer of staff from the EFSF to the ESM was concluded in the first quarter of 2013 and as at 31 December 2013 no staff remained in EFSF.

Staff costs are detailed as follows:

	2013	2012
Salaries and allowances	10,292	123
Social security costs	477	3
Pension costs	3,196	91
Total staff costs	13,965	217

The number of persons employed by ESM is 102 as at 31 December 2013 (1 as at 31 December 2012).

In addition to the cost of ESM employees, ESM has expenses in relation with employees seconded from other International Financial Institutions and in relation with interim and temporary staff used. The related cost amounts to €'000 1,239 for the financial year 2013 (2012: €'000 25) and are accounted for as other administrative expenditures (refer to Note 19).

As described in Note 2.16. upon termination of employment, re-settlement allowance may be paid and the payment of such benefit is subject of conditionality of several criteria. Taking into account the complex structure of those termination benefits and the fact that the Entity has no historical data to estimate the occurrence of such events, no provision is recognised as at 31 December 2013 and 31 December 2012.

19. Other administrative expenditures (in €'000)

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

	2013	2012
Advisory services	5,033	7,586
Outsourced services (mainly IT, HR and accounting services)	4,008	2,178
Treasury related services	1,752	-
Interim and secondment fees (Note 18)	1,239	24
Rental and related services	1,104	110
Legal services	908	2,070
Rating agencies fees	814	1,528
Other miscellaneous expenses	2,018	62
Total administrative expenditures	16,876	13,558

20. 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, Board of Directors were not entitled to remuneration during the period.

Transactions with shareholders

As disclosed in more detail in Note 7, the ESM granted loans to Spain and Cyprus which are also shareholders of the Entity. Moreover 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 in the balance sheet.

Transactions with European Financial Stability Facility

The European Financial Stability Facility (EFSF) is a public limited liability company (Société Anonyme) which was incorporated in the Grand Duchy of Luxembourg under Luxembourg law on 7 June 2010 pursuant to 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 EFSF have been repaid in full. As of 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 setting up 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 has not been paid yet at balance sheet date (refer to Note 13).

The EFSF has asked the ESM to provide certain administrative services and other support services in order to assist EFSF in performing its activities. To formalise such cooperation the ESM and EFSF entered into a Service Level Agreement. Under the terms of the Agreement the ESM charged € 17.0 million to the EFSF for the financial year 2013, which has not been paid yet at balance sheet date (refer to Note 11). The ESM recognised the amount as other operating income in the profit and loss account.

As disclosed in Note 2.6.3. and in Note 8 the ESM invests on a temporary basis in short term notes issued by the EFSF.

21. Audit fee (in €'000)

The total fees accrued are presented as follows:

	2013	2012
Audit fees	261	30
Total Audit fees	261	30

22. Off-balance sheet items

As at 31 December 2013, the off-balance sheet items represent the undisbursed part of the up to 9 billion financial assistance programme to Cyprus, amounting to € 4.4 billion.

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

As at 31 December 2012 the off-balance sheet items represented the undisbursed part of the € 100 billion financial assistance programme to Spain, amounting to € 60.5 billion. On 31 December 2013, the ESM financial assistance programme to Spain expired and as a result any remaining undisbursed funds were automatically cancelled.

23. 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 2013 financial statements.

Chapter

5

External Auditor's Report on the Financial Statements

To the Board of Governors of European Stability Mechanism

We have audited the accompanying financial statements of European Stability Mechanism, which comprise the balance sheet as at 31 December 2013, 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 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 2013, 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
Luxembourg, 3 April 2014

Represented by
Pierre Krier



Chapter

6

Board of Auditors' Report on the Financial Statements

Luxembourg, 3 April 2014

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 31 December 2013 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 2013.

Having examined the first full year of the ESM, the Board of Auditors observes, as detailed in its Annual Report for the year ended 31 December 2013, that the institution has made progress in design and in implementation of internal, operational and managerial controls. The ESM controls framework is still evolving and, against the background of rapidly changing operational and external demands, continues to face challenges in reaching standard practice. The Board of Auditors 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 2013.

On behalf of the Board of Auditors

Katarína Kaszasová

Chairperson

Glossary

(ESM) Annual Report

A report drawn up annually by the Managing Director and approved by the Board of Governors containing a description of the policies and activities of the ESM, the corresponding Financial Statements of the preceding financial year, a 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 ESM Annual Report is published on the ESM's website following approval by the Board of Governors.

Authorised unpaid capital

The portion of the ESM's authorised capital stock consisting of callable shares. These shares may be called in accordance with the terms set in the ESM Treaty (see "capital call"). Following the payment of paid-in capital of over €80 billion the total aggregate nominal value of callable shares is currently €621.9 billion.

Benchmark bond

There are two major definitions for a 'Benchmark bond': a bond that provides a standard against which the performance of other bonds can be measured; a bond which delivers a certain size, liquidity and reputation: For EFSF/ESM, benchmark size is generally meant to be at least €3 billion for maturities up to 10 years and at least €1 billion for maturities above 10 years.

Board of Auditors

An independent body of the ESM mandated to inspect the organisation's accounts and verify that the ESM's operational accounts and balance sheet are in order. The Board of Auditors may inform the ESM Board of Directors at any time of its findings and draws up a report, on an annual basis, to the Board of Governors. This report also becomes accessible to the European and national parliaments, the supreme audit institutions of the ESM Members and to the European Court of Auditors.

Board of Directors

A body in the ESM governance structure with the task to take decisions as provided for in the ESM Treaty or delegated to it by the Board of Governors and to ensure that the ESM is run in accordance with the ESM Treaty and By-Laws adopted by the Board of Governors (for example, the Board of Directors decides on disbursements of assistance to a beneficiary ESM Member). Each Governor appoints one Director and one alternate Director from among people of high competence in economic and financial matters. The European Commission and ECB may each appoint a (non-voting) observer.

Board of Governors

The Board of Governors is the highest governing body of the ESM and comprises Ministers of Finance of the euro area Member States (as voting members). The ECB President and European Commissioner for Economic and Monetary Affairs and the Euro may participate in meetings of the Board of Governors as (non-voting) observers.

Bond/Bill auction

A method of selling bonds and bills on the primary market by national governments and sovereign, supranational and agency (SSA) issuers, where financial institutions place bids on the yield or price of the bond or bill being offered.

Borrowing costs

The costs of obtaining financing on financial markets by the issuance of debt securities (bills, bonds or other funding instruments).

Capital call

The ESM Treaty specifies three types of capital calls: (i) general capital calls to accelerate or increase the payment of paid-in capital, which may be enacted at any time by the Board of Governors; (ii) capital calls to restore the level of paid-in capital, if the amount is reduced by the absorption of losses, which may be made by the Board of Directors; and (iii) emergency capital calls to avoid a default of any payment obligation due to ESM creditors, which may be made by the Managing Director.

Conditionality

Policy conditions that ESM Members receiving financial assistance from the ESM are required to meet before receiving support. These conditions can, for instance, relate to policy measures to be implemented by the beneficiary ESM Member aimed at lowering tax evasion. The policy conditions that a beneficiary ESM Member needs to meet are agreed in a Memorandum of Understanding with the beneficiary ESM Member, which is approved by the Board of Governors of the ESM.

Credit line

Precautionary financial support made available by the ESM to a beneficiary ESM Member establishing a balance that the beneficiary ESM Member is allowed to draw, subject to certain conditions. The ESM offers two types of credit lines: the Precautionary Conditioned Credit Line (PCCL) and the Enhanced Conditions Credit Line (ECCL).

Debt management office (DMO)

A government agency that is responsible for the issue of debt securities and the management of a country's debt.

Direct Recapitalisation Instrument (DRI)

In June 2012, the Heads of State or Government of the euro area stated that a decision could be taken to allow the ESM to recapitalise banks directly when an effective single supervisory mechanism is established for banks in the euro area. In June 2013 the Eurogroup agreed on the key elements of the ESM direct bank recapitalisation instrument, the operating framework is currently being finalised. Activation of the instrument will require a unanimous decision of all euro area Member States.

Diversified funding (strategy)

A strategy that uses a variety of financial instruments and maturities to ensure the efficiency of funding. One feature of this strategy is that funds raised through various instruments are not attributed to a particular beneficiary country. The funds are pooled and then disbursed to programme countries. The size and maturity of the bonds and bills issued therefore do not need to match exactly the size and maturity of the disbursements to a beneficiary country.

Emergency voting procedure

A voting procedure to be used when the European Commission and the ECB both conclude that a failure to urgently adopt a decision to grant or implement financial assistance, as defined in Articles 13 to 18 of the ESM Treaty, would threaten the economic and financial sustainability of the euro area. The adoption of a decision by the Board of Governors to grant stability support under the emergency procedure requires a qualified majority of 85% of the votes cast.

Enhanced Conditions Credit Line (ECCL)

A credit line open to all ESM Members whose general economic and financial situation remains sound but do not comply with some of the eligibility criteria for accessing a Precautionary Conditioned Credit Line (PCCL). The beneficiary ESM Member will be obliged to adopt corrective measures aimed at addressing such weaknesses and avoiding any future difficulties in respect of access to market financing.

ESM Treaty

An intergovernmental treaty signed in Brussels on 2 February 2012 by the 17 EU Member States whose currency is the euro, establishing the European Stability Mechanism. The ESM Treaty entered into force on 27 September 2012 and was amended in March 2014 upon Latvia's accession to the ESM.

Eurogroup

The informal gathering of the Finance Ministers of the euro area Member States. Meetings of the Eurogroup are aimed at enhancing economic policy coordination within the euro area. The Eurogroup is also attended by the EU Commissioner for Economic and Monetary Affairs, the President of the European Central Bank, and the Chairman of the Eurogroup Working Group presenting

the preparatory work done in that Group. The Managing Director of the ESM is regularly invited to Eurogroup meetings. The Eurogroup is chaired by a President, appointed for two and a half years (currently Jeroen Dijsselbloem from the Netherlands).

European Semester

A six-month period each year when EU Member States' budgetary, macroeconomic and structural policies are coordinated so as to allow these countries to translate EU considerations into their national budgetary processes and into other aspects of their economic policy-making.

European Supervisory Authorities (ESAs)

Three EU authorities — the European Banking Authority (EBA), European Insurance and Occupational Pensions Authority (EIOPA) and European Securities and Markets Authority (ESMA) — are responsible for developing guidelines and recommendations for national supervisory authorities, and to draft technical standards (formally adopted by the European Commission as EU law) contributing to the harmonisation of rules applicable to financial institutions.

Financial Assistance Facility Agreement (FFA)

An agreement between the ESM and a beneficiary country, specifying the financial terms and conditions of the stability support instrument provided to the beneficiary country.

Financial assistance instruments

The ESM offers five financial assistance instruments to its Members (all subject to appropriate policy conditionality reflecting the circumstances of the beneficiary ESM Member): precautionary financial assistance (the ECCL and the PCCL), financial assistance for the recapitalisation of financial institutions of an ESM Member, primary market support facility, secondary market support facility, and ESM loans. Financial assistance in the form of ESM loans is subject to a macroeconomic adjustment programme and is intended to assist ESM Members that have significant financing needs but have to a large extent lost access to market financing and have severe problems in their general economic and fiscal situation.

Fiscal Compact (Treaty on Stability, Coordination and Governance in the Economic and Monetary Union)

The Fiscal Compact is an intergovernmental treaty signed by 25 EU Member States on 2 March 2012. It entered into force on 1 January 2013. The Compact requires national budgets to be in balance or in surplus. This means the annual structural government deficit must not exceed 0.5% of GDP. This balanced budget rule must be incorporated into the Member States' national legal systems, through permanent, binding provisions (preferably of a constitutional character) within one year following the entry into force of the Treaty.

Funding

Issuing debt securities or other financial instruments in order to finance loans and other forms of financial assistance to ESM Members.

Intergovernmental organisation

An organisation, such as the European Stability Mechanism, which is established by and composed of sovereign Member States. An intergovernmental organisation should be distinguished from a supranational organisation (such as the European Union) to which Member States cede some sovereign decision-making power in selected policy areas.

Lead manager

The bank(s) mandated by an issuer to arrange the raising of money via a bond, a loan or a share issue. The lead managers form a syndicate which negotiates with the issuer, assesses market conditions and works together with the issuer's funding team on the transaction of raising money.

Lending capacity

The maximum total amount of funds (€500 billion) that the ESM may lend to its Members, as specified in the ESM Treaty.

Macroeconomic adjustment programme

An extensive programme of policy reforms aimed at addressing problems in an ESM Member's general economic and fiscal situation. A macroeconomic adjustment programme is negotiated between the Troika and the beneficiary ESM Member. The implementation of policy reforms set out in the macroeconomic adjustment programme is a precondition for receiving disbursements of ESM loans.

Managing Director

The top executive officer and legal representative of the ESM, who is responsible for conducting its current business. The Managing Director is appointed by the Board of Governors for five years and may be reappointed once. The current Managing Director is Klaus Regling.

Memorandum of Understanding (MoU)

A document concluded by the European Commission, in liaison with the ECB, the IMF (where applicable) and an ESM/EFSF Member, detailing the policy conditions attached to the stability support instrument provided.

Money markets

A segment of financial markets where short-term financial instruments are traded. These include government bills, commercial papers (CPs), certificates of deposits (CDs), repurchase agreements (repos) and also derivatives (such as EONIA swaps) with maturities ranging from one day to one year.

Paid-in capital

The portion of the ESM's authorised capital stock paid in by ESM Members. The payment of paid-in capital was made in five instalments and completed in April 2014. The amount of paid-in capital is approximately €80 billion. Paid-in capital is invested in high quality liquid assets and serves as loss-absorbing capital.

Precautionary financial assistance

A credit line granted to an ESM Member whose general economic and financial situation remains sound. Its aim is to prevent crisis situations by allowing such an ESM Member to secure the possibility to access ESM assistance before it experiences difficulties raising funds in capital markets. Two types of credit line are available: a Precautionary Conditioned Credit Line (PCCL) and an Enhanced Conditions Credit Line (ECCL). Both credit lines can be drawn via a loan or primary market purchase and have an initial availability period of one year and are renewable twice, each time for six months. When precautionary financial assistance is granted, an MoU is concluded with the beneficiary ESM Member.

Primary market support facility

The purchase of bonds or other debt instruments by the ESM issued by Member States via auctions or syndicated transactions. The main objective of primary market support is to allow the ESM Members to maintain or restore their access to financial markets.

Recapitalisation of financial institutions

Financial assistance to ESM Members for the recapitalisation of financial institutions provided in the form of a loan from the ESM to the beneficiary ESM Member. The support is channelled to the beneficiary institution by the ESM Member in accordance with EU state aid provisions. The institution(s) concerned should be of systemic relevance or pose a serious threat to the financial stability of the euro area as a whole or of its Member States.

Secondary market support facility

The purchase of bonds or other debt instruments by the ESM or EFSF issued by Member States on the secondary debt market. The aim of EFSF/ESM secondary market intervention is to support the good functioning of the government debt markets of ESM Members in exceptional circumstances where the lack of market liquidity threatens financial stability.

Seniority

Seniority refers to the order of repayment of debt in the event of a sale or bankruptcy of a borrower/issuer. ESM loans to its Members enjoy preferred creditor status in a similar fashion to those of the IMF, while accepting preferred creditor status of the IMF over the ESM. This does, however, not apply to ESM loans granted to countries under an EFSF programme existing at the time of the signature of the ESM Treaty. By contrast, EFSF loans to Member States are *pari passu*, that is each creditor has a right to be paid *pro rata* in accordance with the amount of its claim.

Single Supervisory Mechanism (SSM)

A new system of financial supervision adopted in October 2013. In the SSM ultimate responsibility for the supervision of systemic euro area banks will lie with the European Central Bank (ECB), while national supervisors will continue to play an important role in day-to-day supervision and in preparing and implementing ECB decisions. The ECB will assume its supervisory responsibilities in November 2014.

Six-Pack

A set of six legislative acts adopted in 2011, enhancing procedures for the surveillance of the EU Member States' fiscal policies (strengthening the Stability and Growth Pact) and macroeconomic policies (with a new Macroeconomic Imbalances Procedure).

In addition to the rules set in the so-called Fiscal Treaty, the Six-Pack creates a formal framework for monitoring macroeconomic imbalances, including an early warning system and mechanisms for correcting imbalances, and lays down minimum requirements for national budgetary frameworks.

Spread

The positive/negative difference between an asset and a benchmark (for example, compared with Germany's debt instruments, the Bund spread, SSA spread). Spreads are commonly quoted in basis points (1 basis point is equal to 0.01%).

Stability and Growth Pact (SGP)

A set of EU budgetary rules agreed in 1997, reformed in 2005 underpinning the Economic and Monetary Union (EMU) and reinforced in 2011 with the Six-Pack. The main aim of the Stability and Growth Pact is to prevent the occurrence of excessive budget deficits, defined as more than 3% of gross domestic product (GDP). Member States are also required to have a level of total public debt of no more than 60% of GDP or be taking steps to reduce it to that level. The SGP requires EU Member States to promptly implement an excessive deficit procedure if it is found to be in serious breach of the rules. The procedure requires a Member State to correct the budget deficit below 3% of GDP within a certain timeframe.

Sovereign, Supranational, and Agency (SSA)

A sector of the bond market which comprises sovereign, supranational and agency issuers. The ESM and EFSF both belong to this category.

Syndication

A method of issuing bonds where a syndicate of several banks underwrite the bonds issued (that is buy the whole issue) and resell the bonds to institutional investors.

Tap ("tapping a bond")

A procedure that allows issuers to sell additional bonds from past issues. The bonds are issued at their original face value, maturity and coupon rate, but sold at the current market price. Increasing issues using a tap to allow an organisation to increase the liquidity of existing bonds.

TARGET2

An electronic payment system owned and operated by the Eurosystem. It enables the speedy and final settlement of national and cross-border payments handled in euros using a single technical platform. The transactions are settled one by one on a continuous basis, in central bank money with immediate finality.

Troika

An informal, collective name for the three institutions (European Commission, European Central Bank and International Monetary Fund) that work together to negotiate policy conditionality for euro area Member States that have applied for financial assistance from the ESM/EFSF (and IMF). Assistance is provided on the condition that the beneficiary Member State implements a package of policy reforms typically involving fiscal adjustment and structural reforms to boost potential growth, create jobs and improve competitiveness. The policy reforms are specified in an MoU, and afterwards the Troika is responsible for monitoring compliance with the policy conditionality.

Two-Pack

Building on the so-called Six-Pack, the EU adopted in 2013 a new set of provisions for enhanced monitoring of euro area Member States' budgetary policies. Euro area Member States are required to submit annually (by 15 October) to the European Commission and the Eurogroup their draft budgetary plans for the next year. Closer monitoring applies to euro area Member States in an excessive deficit procedure to enable the European Commission to better assess whether there exists a risk of non-compliance with the deadline to correct the excessive deficit.

Acronyms and abbreviations

ALM	Asset and Liability Management	FROB	(the Spanish fund for orderly bank restructuring)
Bps	Basis points	GDP	Gross domestic product
BRRD	Bank Recovery and Resolution Directive	HICP	Harmonised Index of Consumer Prices
CDS	Credit default swap	HQLA	High Quality Liquid Assets
CoCos	(bonds that may be converted into equity "contingent" on a specified event)	IMF	International Monetary Fund
COFOG	Categories by function of government	IRC	Internal Risk Committee
CRD	Capital Requirements Directive	LTROs	Longer-Term Refinancing Operations
CRR	Capital Requirements Regulation	MoU	Memorandum of Understanding
DMOs	Debt management offices	MTO	Medium-term budgetary objectives
DRI	Direct Recapitalisation Instrument	NPL	Non-Performing Loans
EBA	European Banking Authority	OECD	Organisation for Economic Co-operation and Development
EBS	(Deutsche Bundesbank's) ESM Bidding System	OMTs	Outright Monetary Transactions
EC	European Commission	PCCL	Precautionary Conditioned Credit Line
ECB	European Central Bank	SAREB	(the Spanish asset management company)
ECCL	Enhanced Conditions Credit Line	SGP	Stability and Growth Pact
EFSF	European Financial Stability Facility	SLEs	Subordinated liabilities exercises
EIOPA	European Insurance and Occupational Pensions Authority	SMEs	Small and medium-sized enterprises
EMU	Economic and Monetary Union	SSA	Sovereign, supranational and agency (bond issuers)
ESM	European Stability Mechanism	SSM	Single Supervisory Mechanism
ESMA	European Securities and Markets Authority	SRB	Single Resolution Board
ESMAT	Administrative Tribunal of the European Stability Mechanism	SRF	Single Resolution Fund
ESRB	European Systemic Risk Board	VaR	Value at Risk
EU	European Union	WAM	Weighted-average maturity
EWS	Early Warning System		
FFA	Financial Assistance Facility Agreement		

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