European Stability Mechanism

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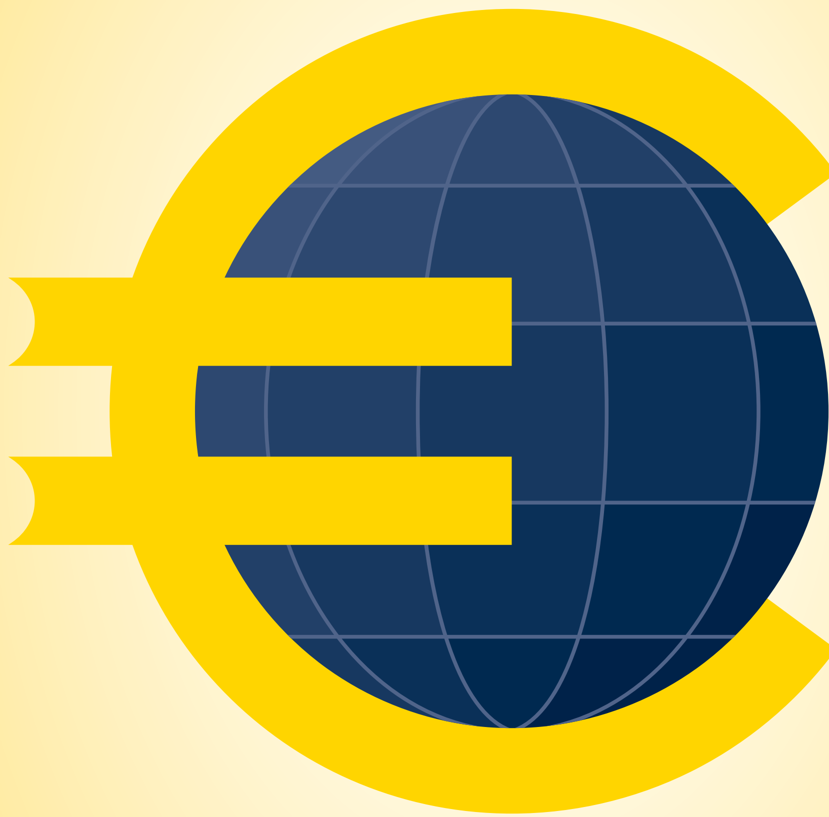

2018 Annual Report

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2018 Annual Report

Contents

5 **ESM at a glance**
7 **Message from the Managing Director**
9 **Letter of transmittal to the Board of Governors**
10 **2018 year in review**
11 **The international role of the euro**

01 ECONOMIC DEVELOPMENTS
13 **Macroeconomic and financial environment**
18 December 2018 Euro Summit marks new chapter for the ESM
21 **Programme country experiences**
23 Greek programme achievements
32 Resilience of countries that benefited from financial assistance

02 ESM ACTIVITIES
37 **Processing the financial transactions of the ESM**
39 **ALM and Lending activities**
42 **Funding and Investor Relations**
46 Major rating agencies affirm ESM's high rating position
47 **Investment and Treasury**
50 **Risk and Compliance**
55 Focus on the Risk and Control Self-Assessment (RCSA) process
56 **ESM: committed to public service, transparency, and accountability**

03 INSTITUTIONAL FRAMEWORK AND ORGANISATION
59 **The ESM financial assistance toolkit**
61 **Governance**
62 Governance structure
63 **Board of Governors**
67 **Board of Directors**
70 **Board of Auditors**
72 **Internal control framework**
74 **ESM organisational structure**

04 FINANCIAL REPORT

78 **Balance sheet**

79 **Off-balance sheet**

80 **Profit and loss account**

81 **Statement of changes in equity**

82 **Statement of cash flows**

83 **Notes to the financial statements**

05 EXTERNAL AUDITOR'S REPORT ON THE 2018 FINANCIAL STATEMENTS

06 REPORT OF THE BOARD OF AUDITORS ON THE 2018 FINANCIAL STATEMENTS

ACRONYMS AND ABBREVIATIONS

ESM at a glance

The European Stability Mechanism (ESM) is a crisis resolution mechanism established by the euro area countries. Since its inauguration in October 2012, the Luxembourg-based ESM has provided financial assistance to ESM Members experiencing or threatened by severe financing problems to safeguard the financial stability of the euro area as a whole and of its member states. Euro area leaders decided to give the ESM, an intergovernmental institution, a stronger role in financial assistance programmes and agreed to changes in its toolkit.

The leaders' agreement foresees that:

- The ESM will provide a backstop for the Single Resolution Fund (SRF), a key element of banking union that is designed to resolve financial problems at systemic banks in an orderly fashion; ESM's backstop loans will be granted as a last resort and be fiscally neutral over the medium term;

- The ESM will take a stronger role in designing, negotiating, and monitoring future programmes, in full respect of the European Commission and European Central Bank (ECB) competences;

- The ESM's precautionary instruments will be reviewed to make them more effective.

For more information on the new mandates, see 'December 2018 Euro Summit marks new chapter for the ESM'.

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

loans to cover their financing needs;

loans and direct equity injections to recapitalise financial institutions;

primary and secondary debt market purchases of Members' national bonds;

credit lines to be used as precautionary financial assistance.

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

Note: The *ESM 2018 Annual Report* contains the audited financial statements as at 31 December 2018, together with the report of the external auditor in respect of their audit concerning these financial statements, and the report of the Board of Auditors in respect of these financial statements. The description of ESM policies and activities covers the 2018 financial year, except when stated otherwise. The information related to the composition of the Board of Governors and Board of Directors reflects their composition as of 7 May 2019. The economic development report (Chapter 1) includes certain information available up to 1 May 2019, but all historic financial data there set out is limited to the period to 31 December 2018.

"The ESM reached two milestones in 2018: Greece exited its ESM programme successfully and European leaders decided on a package of measures to deepen Economic and Monetary Union, including steps to strengthen the ESM."

KLAUS REGLING
Managing Director
European Stability Mechanism

Message from the Managing Director

The ESM reached two milestones in 2018: Greece exited its ESM programme successfully in August after more than eight years under financial assistance, and the Euro Summit decided in December on a package of measures to deepen Economic and Monetary Union (EMU), including steps to strengthen the ESM.

Greece's successful programme exit followed those of Ireland, Spain, Cyprus, and Portugal. With loans of almost €204 billion from the ESM and its temporary predecessor, the EFSF, Greece has benefited from the largest financial assistance in modern history, making the rescue funds the country's biggest creditor by far. Thanks to our loans' low interest rates and long maturities, Greece saved €13 billion in its 2018 budget alone compared to market financing, calculations for this Annual report show. This amount represents 7% of Greek GDP. Similar savings will be repeated over many years to come. This is an unprecedented act of solidarity by the other euro area member states with Greece.

In a further gesture of support, the Eurogroup approved medium-term debt relief measures for Greece in June. They concern an abolition of step-up interest rate margins, a further 10-year deferral of interest and amortisation, and a 10-year extension of the maximum weighted average maturity, all related to EFSF loans. We estimate that this will lead to a cumulative reduction of Greece's debt-to-GDP ratio of around 30 percentage points until 2060. We also expect Greece's gross financing needs to fall by around eight percentage points over the same time horizon. As a result of these medium-term measures, Greece will not start repaying most of its EFSF loans before 2033, and the new weighted average loan maturity has been extended to 42.5 years. All of this comes on top of sizeable short-term debt relief measures implemented in 2017 for Greece.

Also for the longer term, Greece received reassurance on its debt sustainability. The euro finance ministers committed to reviewing in 2032 whether additional debt measures are needed to respect Greece's agreed gross financing needs targets. There is also a contingency mechanism on debt, which could be activated should Greece be hit by an unexpectedly adverse scenario. If the Eurogroup were to activate the mechanism, measures could include further re-profiling, and capping and deferral of interest payments to the EFSF to the extent needed to meet the gross financing needs targets.

In return, Greece pledged to stick to the reforms agreed under the programme, among them to maintain a primary surplus of 3.5% until 2022 and to comply with EU rules, particularly related to fiscal and economic policies.

In an effort to continuously improve the work of the ESM, Mário Centeno, the Chairperson of the ESM Board of Governors, and I have asked former European Commission Vice President Joaquín Almunia to lead an independent evaluation of the financial assistance to Greece. We are looking forward to an interim report of his work in December 2019 and to the opportunity to consider his results at the ESM Board of Governors' Annual Meeting in June 2020.

With Greece's programme exit, the ESM accomplished its immediate mission to overcome the euro crisis and to safeguard financial stability in the euro area by providing loans in exchange for economic policy reforms. The ESM can now focus on implementing the December Euro Summit decisions to be better prepared for the next crisis.

The year-end summit decisions illustrate both Europe's determination to make the euro area more resilient and the political will to move EMU forward even without the threat of an existential crisis. The decisions also show that the ESM has become a key pillar in the currency union's institutional architecture.

According to the Euro Summit, the ESM receives a broadened mandate and becomes the backstop for bank resolution within banking union. This backstop will only be activated if the funds of the Single Resolution Fund are insufficient to resolve a bank in crisis. To repay its loans to the ESM within three-to-five years, the SRF would receive levies from European banks. As is the case with all country programmes, there will be no transfer of taxpayers' money. By 2024 at the latest, the backstop will be fully operational.

The ESM will also play a stronger role in future programmes in close cooperation with the European Commission and in full respect of its prerogatives according to the EU Treaty. Together with the Commission, the ESM will design, negotiate, and monitor future programmes. Building on the Memorandum of Understanding (MoU) signed in April 2018, the ESM and the Commission agreed in November on their future cooperation and the Euro Summit endorsed the agreement. The two institutions will work in tandem, drawing strength from the complementarity of our respective expertise.

Additionally, the Euro Summit decided to make the ESM precautionary credit lines more efficient and easier to use, and to strengthen the role of the ESM in matters of debt sustainability. It is the ESM's role to take a creditor's perspective. In the future, the Commission and the ESM will jointly prepare a debt sustainability analysis for programme countries. In addition, when appropriate, and if requested by the Member State, the ESM may facilitate the dialogue between its Members and private investors. This involvement would take place on a voluntary, informal, non-binding, temporary, and confidential basis.

Furthermore, the euro area intends to introduce single limb collective action clauses by 2022 and to include this commitment in the ESM Treaty. These Euro Summit decisions are not intended to lead to more debt restructurings but to more transparency and predictability.

Lastly, the summit mandated the Eurogroup to work in two areas where Member States still have very different views: a common European deposit insurance scheme and a budgetary instrument for convergence and competitiveness of the area.

We know that a European deposit insurance is important for the completion of banking union. Views diverge on the preconditions needed, but it would ultimately be very beneficial to overcome the fragmentation of Europe's financial markets. Also, the past ESM and EFSF programmes would have been much smaller if we had had a common deposit insurance.

Regarding the euro area budget, the summit asked the finance ministers to work on the design, the modalities of implementation, and the timing of the budgetary instrument for convergence and competitiveness. This is a positive step as it will encourage structural reforms and strengthen competitiveness in the euro member states. This will enhance the resilience of the monetary union as a whole.

I also see good economic reasons to talk about fiscal instruments for macroeconomic stabilisation. There are several proposals on the table that would not lead to permanent transfers. Following the European elections, I would welcome broadening the discussion. We could also consider a revision of the fiscal rules, to make them more effective, and a stabilisation facility at the euro area level operating outside a crisis situation. But this is beyond the current political mandate.

The efforts to deepen EMU and enhance its resilience, together with the completion of banking union and capital markets union, would also help to strengthen the international role of the euro. A more balanced multipolar currency system that comprises the US dollar, the euro, the renminbi, and perhaps one or two other currencies would, over time, improve the functioning of the international monetary system and protect Europe's interests.

Letter of transmittal to the Board of Governors

13 June 2019

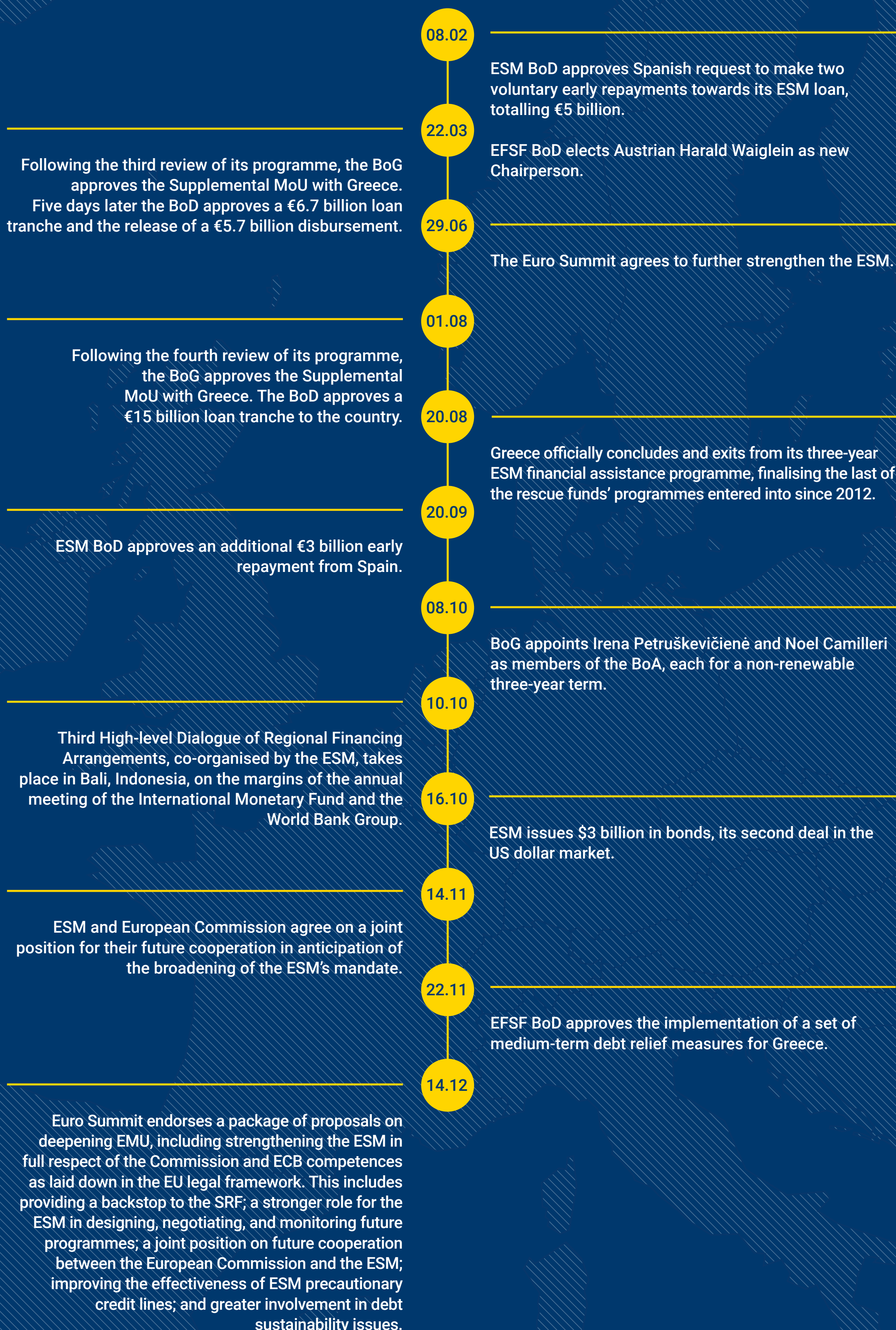
Dear Chairperson,

I have the honour of presenting to the Board of Governors (BoG) the annual report in respect of the financial year 2018, in accordance with Article 23(2) of the By-Laws of the European Stability Mechanism (By-Laws).

The annual report includes a description of the policies and activities of the European Stability Mechanism during 2018. It also contains the audited financial statements as at 31 December 2018, as drawn up by the Board of Directors (BoD) on 26 March 2019 pursuant to Article 21 of the By-Laws, which are presented in Chapter IV. Furthermore, the report of the external auditor in respect of the financial statements is presented in Chapter V and the report of the Board of Auditors (BoA) in respect of the financial statements in Chapter VI. The independent external audit was monitored and reviewed by the BoA as required by Article 24(4) of the By-Laws.

Klaus Regling
Managing Director

2018 year in review



The international role of the euro

Public debate and market interest in the international role of the euro rose in 2018, partly in response to a more sceptical attitude of the US towards the established multilateral system. Some observers have argued that the international monetary system could become more multipolar, where next to the dollar, the euro and the renminbi play a more significant role, thereby making the system more balanced.

The European Commission, some central bank officials, and the ESM have all recently addressed the matter.[1] In December 2018, the Euro Summit encouraged further work, taking note of a related European Commission communication.[2] The summit adopted an agenda to deepen monetary union and to strengthen the ESM, both pre-conditions to strengthening the international role of the euro. Another important step is to further enhance financial market integration.

Given the topic's relevance, it was an appropriate time for the ESM to ask its Governors, the 19 euro area finance ministers, to share their views on the subject. You will read their individual perspectives throughout these pages.

The euro is the world's second-most important currency, although its role suffered during the European sovereign debt crisis. About 20% of allocated foreign currency reserves are held in euros, and the common currency was used in over 30% of global payments in 2017.[3]

There are several structural factors that explain why the euro is trailing the US dollar on an international scale, which can be addressed by pushing ahead with the December 2018 agenda to deepen monetary union. Euro-denominated financial markets are smaller than those denominated in US dollars,[4] and European markets are also more fragmented. Without more integrated and liquid financial markets, it will be challenging for the euro to play a stronger role in the global currency system than that commensurate with its share in world trade.

When reflecting on the euro's international role, the ESM Governors made important points. For some ministers, a strengthened international euro role is a matter of sovereignty and one that provides better protection for Europe. Others insist that work on the resilience of monetary union is the key as it is market participants who decide on a currency's use. Most shared the view that deepening Economic and Monetary Union (EMU), and completing both banking union and capital markets union, would contribute to a stronger international role for the euro. This view is also shared by many international investors.

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1 European Commission (2018) ,'President Jean-Claude Juncker's State of the Union address 2018', 12 September 2018. http://europa.eu/rapid/press-release_SPEECH-18-5808_en.htm;
ECB (2019), 'The euro's global role in a changing world: A monetary policy perspective', 15 February 2019. https://www.ecb.europa.eu/press/key/date/2019/html/ecb.sp190215~15c89d887b.en.html;
ESM (2018), 'The future of the Economic and Monetary Union and the role of the ESM', Speech, 28 November 2018. https://www.esm.europa.eu/speeches-and-presentations/future-economic-and-monetary-union-and-role-esm-speech-klaus-regling

2 European Commission (2018), 'Towards a stronger international role of the euro' 5 December 2018: https://ec.europa.eu/info/sites/info/files/com-2018-796-communication_en.pdf

3 International Monetary Fund COFER and SWIFT data, cited in ECB: The international role of the euro, Interim report, June 2018.

4 The outstanding stock of US dollar-denominated fixed income securities, for example, is more than one-and-a-half times the stock of euro-denominated fixed income securities. And for safe assets (sovereign and SSA bonds rated AA- or above), the contrast is even more striking, as US-dollar denominated bonds account for over 70% of the outstanding stock, according to ESM estimates based on Bloomberg data.

01 Economic developments

Macroeconomic and financial environment

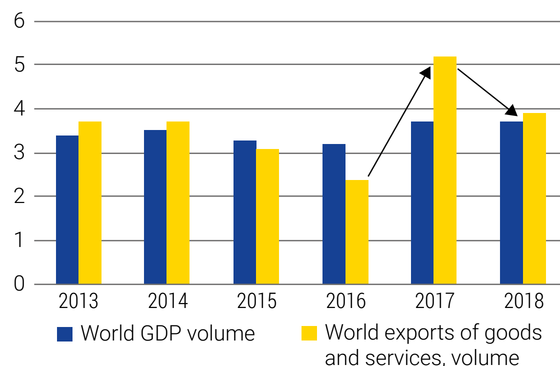
The euro area economy continued to grow in 2018, albeit at a slower pace than in 2017, in line with the maturing global economic cycle. Global growth deceleration is reflected in the slowdown of both advanced economies and emerging markets. Still, the euro area economy is supported by improvements in labour markets, the accommodative monetary stance, and the available fiscal space in some countries. These fundamentals should support a gradual adjustment to weaker global activity. The outlook remains positive, but the overall balance of risks tends to the downside due to trade disputes, Brexit, and geopolitical tensions.

Euro area economic performance moderates

After the peak of economic growth in 2017, euro area growth slowed, following the cyclical downturn of the global economy. In addition to a maturing cycle, trade disputes and Brexit have set a less dynamic path for global trade that, starting from 2018, is expected to converge with lower world gross domestic product (GDP) growth (Figure 1). Oil prices continued to fall while the euro exchange rate (Figure 2) remained broadly stable in nominal terms. US growth held up on the back of fiscal stimulus, but its impact is fading, adding to the downside risks for the euro area.

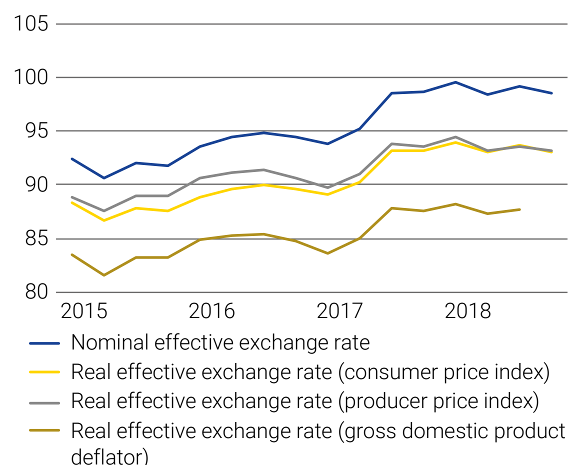
Euro area GDP growth eased to 1.8% in 2018 after expanding by 2.4% in 2017. Apart from weaker external demand, some temporary factors affecting the car industry in the second half of 2018 contributed to the overall deceleration.

Figure 1
World economic activity and exports of goods and services
(y/y growth, in %)



Source: European Commission forecast-Autumn 2018

Figure 2
Euro effective exchange rate
(Group of 19 countries, Q1/1999=100)



Source: European Central Bank

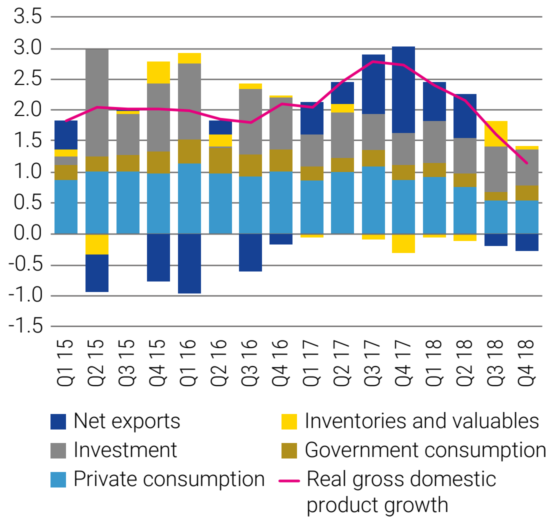
The composition of euro area GDP also reflects the weaker global environment (Figure 3). After sizeable positive contributions in 2017 and the first half of 2018, net export contribution to growth turned negative. This impact is partly offset by the build-up of inventories mostly seen in the third quarter and to a great extent related to the abovementioned one-off factors. Both investment and total consumption remained robust pointing to improvements in the business climate and labour market recovery followed by considerable wage increases.

The slowdown appears to be synchronised, with all large euro area countries recording more moderate growth rates (Figures 4 and 5). While countries differed noticeably in their cyclical position and labour market improvements, the synchronised slowdown could also delay further convergence of euro area members.

Figure 3

Contributions to real gross domestic product growth

(y/y growth in %, contributions in percentage points)

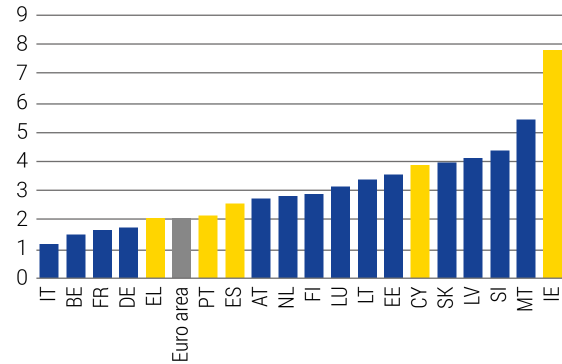


Source: Eurostat

Figure 4

Real gross domestic product growth in 2018

(in %)



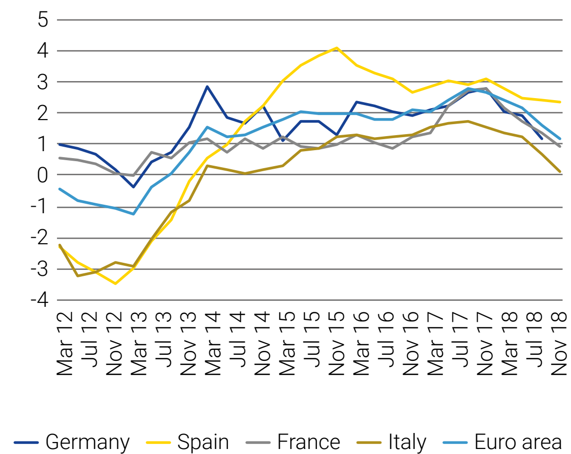
Note: EFSF/ESM programme countries in yellow.

Source: European Commission Economic Forecast-Autumn 2018

Figure 5

Real gross domestic product growth for selected countries

(y/y growth in %, quarterly data)



Source: Eurostat

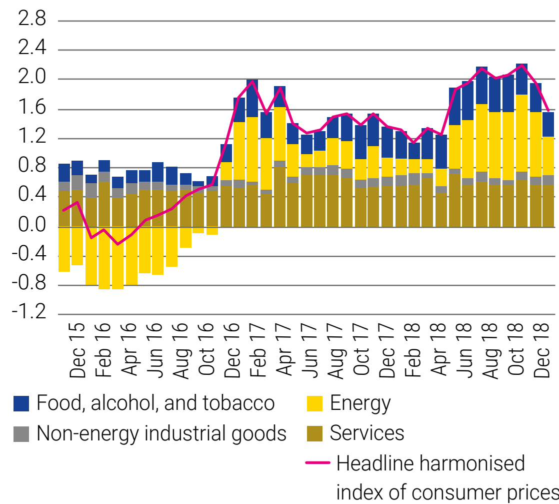
"More action is needed to strengthen the international role of the euro. There are short-term measures we can take, but nothing replaces the credibility boost that completing our Economic and Monetary Union would produce. This would support our economies, protect our social model, and make Europe's voice heard across the world."

MÁRIO CENTENO

Minister of Finance, Portugal,
Chairperson of the ESM Board of Governors

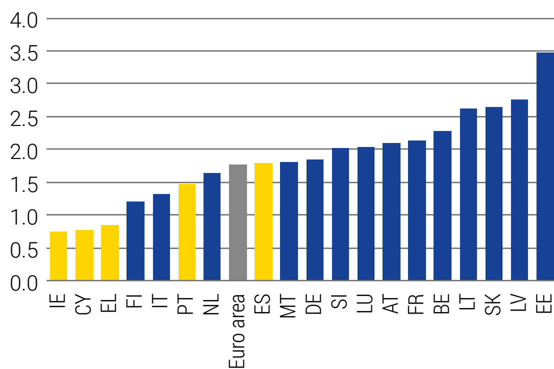
Euro area inflation reached a six-year high in 2018, averaging 1.7% over the year, up from 1.5% in 2017 (Figures 6 and 7). The slight upswing was mostly driven by the energy component given the recovery in oil prices. Core inflation, measured as headline inflation excluding unprocessed food and energy prices, marginally accelerated to 1.2% from 1.1% in 2017. Inflation expectations rose over the year, supported by the oil price recovery and broad-based wage acceleration among euro area member states, which should support core inflation in the future.

Figure 6
Contributions to harmonised index of consumer price inflation rate
(y/y inflation in %, contributions in percentage points)



Source: Eurostat

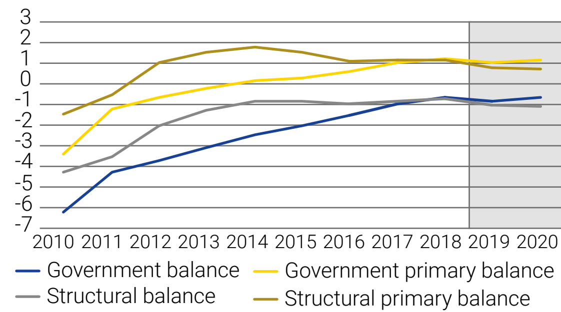
Figure 7
Harmonised index of consumer price inflation rates in 2018
(in %)



Note: EFSF/ESM programme countries in yellow.
Source: Eurostat

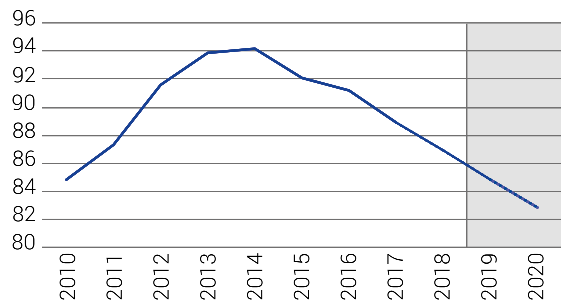
Fiscal balances in the euro area continued improving in 2018 in an environment characterised by favourable borrowing conditions (Figure 8). Low financing costs and cyclical conditions helped governments to compensate for the lack of improvement in structural balances, particularly for countries with high levels of debt. Overall, debt dynamics at the euro area level remained favourable as the debt-to-GDP ratio continued its decline (Figure 9).

Figure 8
Euro area budget balances
(in % of GDP)



Note: Shaded area=forecast
Source: European Commission Economic Forecast-Autumn 2018

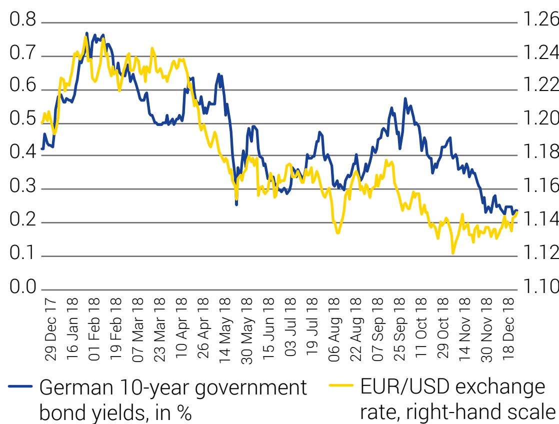
Figure 9
Euro area government debt
(in % of GDP)



Note: Shaded area=forecast
Source: European Commission Economic Forecast-Autumn 2018

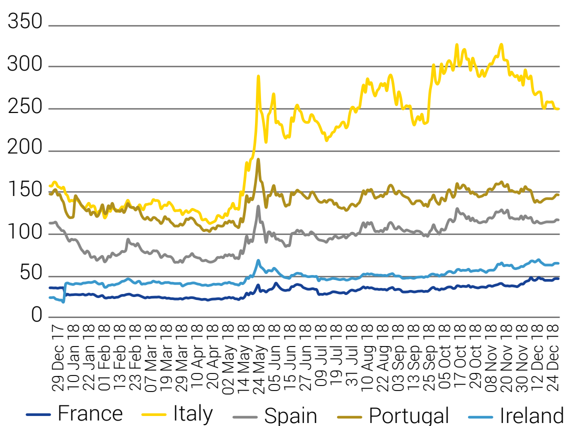
The ECB's monetary policy normalisation, by tapering its net asset purchases, proceeded smoothly in 2018, but the global slowdown and US Federal Reserve's dovish monetary policy response led markets to expect a more cautious monetary policy tightening from the ECB going forward after it announced a new series of targeted longer-term refinancing operations. While the euro weakened and German bund yields declined (Figure 10), sovereign credit spreads (Figure 11) widened to various degrees across the euro area. Market volatility resurfaced, fuelled by idiosyncratic risks, such as Brexit and policy uncertainty in Italy, but these challenges remained contained and did not become systemic. Against this backdrop, countries that had previously undertaken adjustment programmes remained resilient and retained stable market access. For more information on this topic, see 'Resilience of ex-programme countries and limited contagion'.

Figure 10
German bond yields and the euro exchange rate



Source: Bloomberg

Figure 11
10-year sovereign credit spreads of selected euro area member states vs Germany
(in basis points)



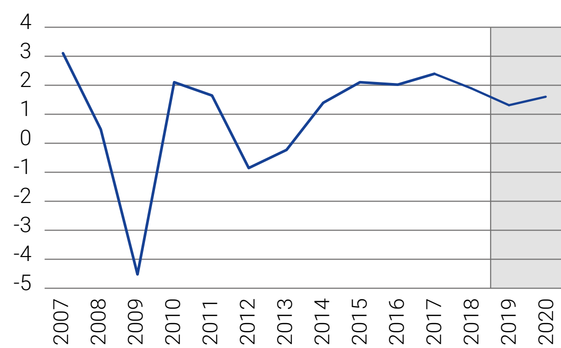
Source: Bloomberg

Euro area heads towards a soft landing in line with a maturing global cycle

The euro area is expected to lose some momentum in line with global trade and output trends (Figure 12), but fundamentals should sustain domestic demand, cushioning somewhat the effects of the global trade slowdown. The ECB's still accommodative monetary policy, the potential use of fiscal stimulus by countries with fiscal space, the strong labour market conditions in some countries, and wage acceleration could strengthen domestic demand in the coming period. Still, labour market shortages could cap euro area growth. Moreover, increases in compensation per employee may pose challenges for countries with low productivity gains, as post-crisis competitiveness gains may erode. Overall, therefore, risks to the euro area growth outlook have moved to the downside. Uncertainties relate to global trade disputes, Brexit negotiations, the possibility of a US slowdown, and other political risks.

The outlook for inflation also shows risks to the downside. The capacity of corporates to pass higher energy and wage input costs to final consumer prices is diminishing. The latest oil price decline, together with the global slowdown and the low pass-through of wages to final prices, increased downside risks for inflation looking forward (Figure 13).

Figure 12
Euro area real gross domestic product growth forecast
(in %)

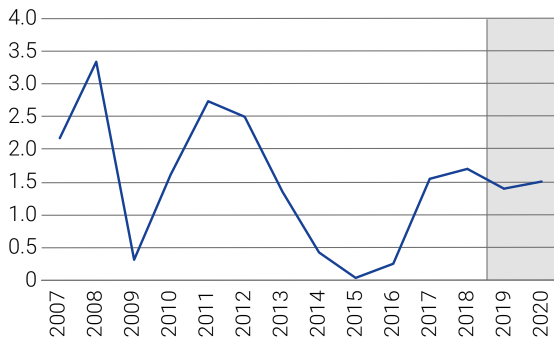


Note: Shaded area=forecast
Source: European Commission Economic Forecast-Winter interim forecast 2019

"Although the euro is the second international currency, the crisis and recent tensions demonstrate that a strengthening of the international role of the euro is warranted. Delivering on Economic and Monetary Union and capital markets union is crucial. Creating a stable economic and financial environment will better protect European citizens and businesses and contribute to higher global growth."

ALEXANDER DE CROO
Deputy Prime Minister, Minister of Finance and Development Cooperation, Belgium, ESM Governor

Figure 13
Euro area inflation forecast
(in %)



Note: Shaded area=forecast
Source: European Commission Economic Forecast-Winter interim forecast 2019

While the US Federal Reserve paused its tightening cycle, monetary policy normalisation in Europe is expected to continue at a very gradual pace. In the first half of 2019, markets focused on the ECB's new series of targeted longer-term refinancing operations, and subsequently attention may shift to the outlook for policy rates. Liquidity provision and the potential for new monetary policy tools may also come under market scrutiny. Against this backdrop, sovereign credit spreads will most likely be driven by country-specific factors, including markets' perception of political risks. Nevertheless, progress on EMU deepening can mitigate the risk of unwarranted financial market volatility.

December 2018 Euro Summit marks new chapter for the ESM

The Euro Summit endorsed a package of measures to deepen EMU, assigning the ESM a stronger role in safeguarding financial stability.

In December, the Heads of State or Government endorsed a package of reforms to reinforce the resilience of the euro area. The measures included enhancing the ESM's role, as well as a commitment to work on completing banking union and designing a budgetary instrument for convergence and competitiveness for the euro area countries. The agreement on the ESM's future built upon the recognition of its effectiveness in providing stability support to euro area members and on the understanding reached between the European Commission and the ESM on their future cooperation. This marks an important milestone in the institution's further development.

The package of proposals included a Term sheet on ESM reform, agreed by the euro area finance ministers at their December Eurogroup meeting, and reproduced in full:

Term sheet on the European Stability Mechanism reform — 4 December 2018

The European Stability Mechanism (ESM) has played a key role in crisis management by providing timely and effective stability support to euro area member states in order to safeguard the financial stability of the Euro Area as a whole and of its Member States. The ESM will be further developed to strengthen the resilience and crisis resolution capacities of the euro area. The ESM will notably take a stronger role in the design, negotiation and monitoring of financial assistance programmes and will provide a backstop for the Single Resolution Fund (SRF), in full respect of the Commission and ECB competences as laid down in the EU legal framework. The Commission and the ESM, within their respective competences and according to the modalities agreed in their joint position on future cooperation, will follow and assess macroeconomic and financial risks as well as debt sustainability. The Commission and the Managing Director of the ESM will sign the MoU detailing the conditionality. Conditionality remains an underlying principle of the ESM Treaty and all ESM instruments, but the exact terms need to be adapted to each instrument.

Common backstop to the SRF

At the latest by the end of the transition period the common backstop will be established. The ESM will provide the common backstop to the SRF in the form of a revolving credit line. The terms of reference on this backstop are attached. The size of the credit line will be aligned with the target level of the SRF and will have a nominal cap set above the initial size.

Equivalent treatment will be ensured with non euro area member states participating in the Banking Union, via parallel credit lines to the SRF as well as appropriate governance arrangements.

The backstop will be a last resort instrument subject to the principle of fiscal neutrality in the medium term.

The common backstop will cover all possible uses of the SRF, according to the current regulation, including liquidity provision, subject to, where needed, adequate safeguards, to be discussed in 2019. These safeguards should be without prejudice to the existing legal competences of the ECB and the SRB. The Direct Recapitalisation Instrument will be replaced by the common backstop at the time it is introduced.

Procedures will be put in place to allow for swift and efficient decision making to fit the timeline of resolution, whilst respecting national constitutional requirements.

Disbursements under the common backstop will be approved by a unanimous decision of the ESM Board of Directors guided by a number of criteria.

The backstop will be introduced earlier provided that sufficient progress has been made in risk reduction to be assessed in 2020. We endeavour to find an agreement on limited Intergovernmental Agreement (IGA) changes. Risk reduction requirements will be commensurate with the level of ambition of the common backstop in the transition period compared to that of the steady state.

The political decision on the early introduction of the backstop will be informed by the assessment of the institutions and competent authorities in 2020 including with respect to minimum requirement for own funds and eligible liabilities (MREL) build-up and trend in non-performing loans (NPLs) reduction.[5] The SRF should be able to access the backstop for banks of all participating Member States.

ESM toolkit

The effectiveness of precautionary instruments will be enhanced for countries with sound economic fundamentals, which could be affected by an adverse shock beyond their control.

As regards the precautionary conditioned credit line (PCCL), the eligibility process will be made more transparent and predictable. The existing ex ante eligibility criteria assessing the sound economic and financial performance of the Member State concerned will be clarified.

They will be used in an assessment on the basis of quantitative and qualitative elements related to the economic and fiscal performance of Member States.

As a rule, Member States need to meet quantitative benchmarks (i.e the debt benchmark, the minimum benchmark and a deficit below 3% of GDP[6]) and to comply with qualitative conditions related to EU surveillance (i.e not experiencing Excessive Imbalances and not being subject to the Excessive Deficit Procedure).

Sustainability of general government debt will always be needed.

A formal commitment from the eligible beneficiary Member State to continuous adherence to the ex ante eligibility criteria (highlighting the main elements of its policy strategy) would take place at the moment the facility is approved by the BoG in a Letter of Intent (LoI) signed by the beneficiary Member State.

Compliance with the ex ante eligibility criteria will be assessed at least every six months by the competent institutions. In case of non-compliance, access to the funds would be discontinued. Upon the Member State's request, and in line with ESM decision-making processes, the arrangement can be changed to an enhanced conditions credit line (ECCL) or a full macroeconomic adjustment programme.

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[5] This assessment will be made against the aim of 5% gross NPLs, and 2.5% net NPLs or adequate provisioning, for all SRB banks and progress thereto. Banks should build up subordinated bail-in buffers steadily in line with the 2024 targets and 2022 intermediate targets. There should be appropriate monitoring by the competent authorities to assess progress. As regards NPLs reduction, competent authorities define individual strategies for the reduction of NPL stocks for relevant banks. In case these aims are not met, Member States will undertake specific efforts also involving their insolvency/debt enforcement regimes to reach these goals in a short period of time.

[6] The minimum benchmark is the level of the structural balance providing a safety margin against the 3% Treaty threshold under normal cyclical conditions. It is mainly used as one of three inputs into the calculation of the minimum MTO. The debt benchmark requires a Member State to have a debt to DGP ratio below 60% or a reduction in this ratio of 1/20th per year. The three benchmarks need to be met in the 2 years preceding the request for support.

The ECCL instrument will continue to be available as foreseen in the current ESM guideline. Access to an ECCL shall be open to ESM Members that do not comply with some of the eligibility criteria required for accessing a PCCL but whose general economic and financial situation remains sound.

As regards the financing terms of precautionary instruments, the margin will be set at 35 bp in case of an extension of maturities, a step-up margin of 50 bp will be applied.

Once the credit line is drawn, in case of non-compliance with the LoI for the PCCL or with the MoU for the ECCL, which is not due to events outside the control of the government as assessed by the ESM BoD, an additional margin of 50 bps will be applied, which increases by 65 bp after six months, and access to the funds would be discontinued.

Debt sustainability issues

There is broad support for the need to improve the existing framework for promoting debt sustainability in the euro area. We intend to introduce single limb collective action clauses (CACs) by 2022 and to include this commitment in the ESM Treaty. We also reaffirm the principle that financial assistance should only be granted to countries whose debt is sustainable and whose repayment capacity is confirmed. This will be assessed by the Commission in liaison with the ECB, and the ESM as described in the attached working arrangements. The debt sustainability assessment will be done on a transparent and predictable basis, while allowing sufficient margin of judgement.

Finally, when appropriate and if requested by the Member State, the ESM may facilitate the dialogue between its Members and private investors. This involvement would take place on a voluntary, informal, non-binding, temporary, and confidential basis.

Cooperation between the ESM and the Commission

The ESM and the Commission have also agreed on new modalities of cooperation within and outside financial assistance programmes, in full respect of the EU legal framework (see joint position on future cooperation between the European Commission and the ESM in annex). This agreement is without prejudice to the role and competences of the ECB as defined in the existing legal framework.

"Twenty years after its introduction, the euro plays an important international role. Since market participants ultimately decide on the use of a currency, it is important to ensure trust in the euro. Increasing the resilience of Economic and Monetary Union, including the deepening of banking union and capital markets union, and strengthening the competitiveness of its member states are key elements in this."

OLAF SCHOLZ

Federal Minister of Finance, Germany, ESM Governor

Programme country experiences

Ireland

EFSF

The Irish economy grew strongly in 2018, backed by buoyant domestic economic activity. Year-end data point to a small Exchequer cash surplus for 2018, driven by over-performing corporate tax receipts. Irish banks showed capital and liquidity buffers well above regulatory requirements, but long-term arrears, sectoral changes, and operational efficiency represent key challenges. The main risks to the economic outlook stem from Brexit, volatility related to the activity of multinational companies, and an overheating of the economy in the medium-run. These risks warrant the prudent accumulation throughout the upcoming years of a fiscal capacity.

Real GDP grew at an annual rate of 6.7% in 2018. Domestic demand indicators support the evidence of strong growth despite distortions from multinational corporations. Domestic demand adjusted for the activities of multinationals grew at an annual rate of 4.5% during the year, driven by private consumption and domestic components of investment.[7] The latest release for unemployment was 5.6% in February. The strong labour market and the still tight housing market represent supply-side constraints that could hamper future growth.

Consumer price inflation (CPI) remained subdued in 2018 despite robust internal demand and sustained employment growth. Goods prices are the main drag on inflation due to weak sterling and an improvement in the calculations of some CPI components, although their combined negative effect on prices is less than offset by increases in housing rents and higher service and energy prices.

Ireland's general government balance was close to balance in 2018, as the Exchequer recorded a small surplus by end-2018. This is mainly due to better-than-expected corporation tax receipts. The high reliance of Ireland on this potentially unstable source of revenues makes the Irish fiscal position relatively vulnerable. Persistent slippages in health sector expenditures could further increase the fiscal vulnerability in Ireland. The general government debt remains above €200 billion and the debt-to-GDP ratio for 2018 was at 64%. However, such a ratio may be an imprecise measure of the debt burden for the economy given that the activities of multinational enterprises distort the GDP figures.

Ireland enjoys favourable market access. In 2018, it issued over €17 billion in benchmark bonds with a weighted average maturity at issuance of 11.8 years, and a weighted average yield at issuance of 1.1%. The National Treasury Management Agency has taken advantage of the favourable market conditions brought by the ECB's asset purchases to lengthen the maturity profile of the debt and to reduce its average interest rate. Buy and sell orders of Irish government bonds were quite balanced during the second half of 2018, according to high-frequency indicators, following a spike in volatility in European sovereign bond markets in May. Strong economic growth, sizeable cash buffers, and an 'A' credit rating support Ireland's favourable market access.

Irish banks showed signs of recovery in an improving operating environment. Banks' active engagement in portfolio sales and restructuring helped to reduce non-performing loans (NPLs). However, the share of mortgages in long-term arrears is still sizeable. NPL resolution activities contributed to further reducing the coverage ratio, which compares unfavourably to the euro area average. Nevertheless, Irish banks' capital and liquidity ratios sit well above the regulatory minimum requirement and provide additional buffers. In the long term, increasing competition and sectoral changes require banks to increase their digital capacity and improve their operational efficiency to stay profitable.

Under its Early Warning System, the ESM's monitoring shows very limited risks for Ireland in meeting its loan service payments. However, Ireland faces a number of external downside risks and, potentially, an overheating domestic economy approaching full employment. These risks warrant the prudent accumulation throughout the upcoming years of a fiscal capacity and close monitoring of Ireland's macroeconomic and financial market dynamics.

[7] Final modified domestic demand is composed of private and public consumption, and modified gross fixed capital formation (excluding aircraft related to leasing and R&D related intellectual property). Change in inventories is excluded given its high volatility.

Greece

esm efsf

After Greece exited its ESM programme in August 2018, the European Commission activated enhanced surveillance for the initial post-programme period and Greece rejoined regular European economic policy coordination. The economic recovery proceeded for the second year, and Greece outperformed the fiscal target for the fourth successive year. To secure economic and financial sector improvements as well as to re-establish market trust, Greece needs to consolidate and continue the reforms pursued during the programme.

After the ESM programme ended in August, the Commission activated "enhanced surveillance", under which Greece committed to completing all key reforms adopted under the programme and to specific actions in particular policy areas. To verify Greece's progress with its commitments and in line with the enhanced surveillance framework, regular missions are conducted by the European Commission in liaison with the ECB, in which the ESM participates under its Early Warning System. The Commission's resulting quarterly enhanced surveillance reports also serve as a basis for euro area members' bi-annual decision to release funds related to the Eurogroup's June 2018 debt relief measures. For more information on these and related measures, see 'Greek programme achievements'.

The completion of the third and fourth reviews unlocked €21.7 billion of ESM financing between March and August 2018. During the three-year programme, the ESM disbursed €61.9 billion of the up-to-€86 billion envelope, of which €7 billion was dedicated to arrears clearance and €11.4 billion to the build-up of a cash buffer. Greece's end-2018 cash resources of €26.8 billion are sufficient to cover financing needs for at least two years. Greece raised €3 billion with a 3-year bond in February, but challenging market conditions did not favour another issuance in 2018. In December 2018, the Public Debt Management Agency announced an up-to-€7 billion 2019 issuance programme. Between January and March 2019, it raised €5 billion through the issuance of a 5-year and a 10-year bond.

In 2018, Greece progressed further in clearing its stock of arrears to the private sector. Domestic resources and programme funds decreased the overall stock by more than €8 billion since the arrears clearance programme started in June 2016. To pay remaining arrears of €1.4 billion in December 2018 and stop creating new ones, Greece has needed to intensify efforts to further modernise its public financial management system.

Greek banks meet capital requirements as of end-2018 and liquidity is much improved, but they still suffer from the highest euro area NPL ratio. Banks have broadly met supervisory targets on NPL reduction to end-2018 but the targets are becoming increasingly challenging. The government improved the efficiency of the out-of-court workout law and the electronic auction platform for asset sales. It also began assessing how it can further support the banks, for example through an asset protection guarantee scheme. The Hellenic Financial Stability Fund (HFSF) developed a strategy for the sale of its stakes in the systemic banks in the following years.

The Hellenic Corporation of Assets and Participations (HCAP) launched governance and operational reforms of state-owned enterprises, and restructured its real estate management entity.

The conclusion of the ESM programme in 2018 and Greece's ongoing commitments helped to improve confidence, but challenges to sustainable growth remain. Economic activity rose by 1.9%, driven by net exports and consumption which compensated for weak investments. General government debt is still high at 181.1% of GDP. The primary surplus reached 4.4% of GDP, according to Eurostat. This implies a primary surplus of 4.3% in programme terms, outperforming the fiscal target of 3.5% of GDP in 2018, the fourth year of outperformance. While income taxes were robust, lower-than-envisaged public investment also boosted the surplus. The authorities legislated a new set of fiscal measures in 2018, cancelling the accelerated recalibration of pensions in line with the pension reform of 2016 that was scheduled to be implemented in 2019. The resulting higher expenditure reduces the financial scope for growth-enhancing policies. For the future, it will be important that Greece combines its post-programme commitments with policies and public investments that support the economy's recovery, strengthen market confidence, and sustain growth.

Greek programme achievements

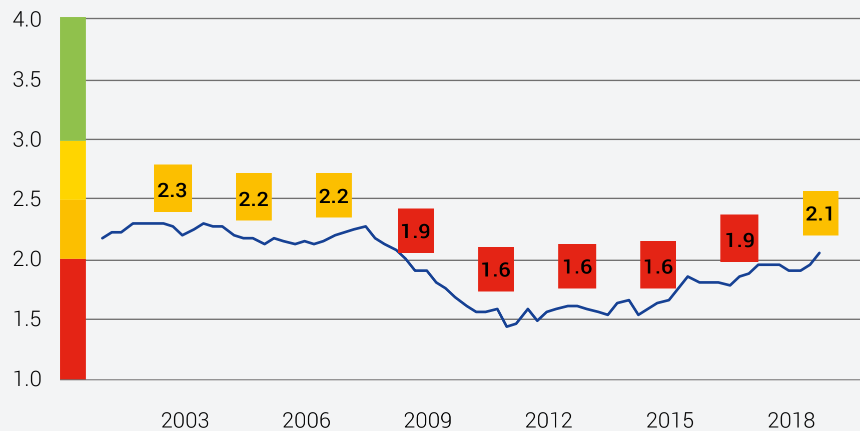
In August 2018, Greece exited its third financial assistance programme after a decade of adjustment. During these years, Greece implemented substantial reforms to restore sustainability to public finances, strengthen the banking sector's resilience, and improve the economy's competitiveness. During this time, Greece received almost €290 billion in official sector financial assistance and extensive debt relief. To enhance Greece's long-term growth potential as well as to protect European partners' large exposure, key programme reform successes must be preserved and prudent policies pursued. Greece's still existing vulnerabilities and challenging reform targets will require closer post-programme country monitoring than the other euro area post-programme countries for some time.

What has been achieved?

According to the ESM Sovereign Vulnerability Index,[8] Greece's vulnerabilities have declined substantially since 2009, when the current account deficit exceeded 12% of GDP and the fiscal deficit 15% of GDP (Figure 14). During the adjustment years, Greece steered its economy to safer waters by improving fiscal and external balances, reducing labour costs, and making the banking sector more resilient (Figure 15).

Greece reduced its macroeconomic imbalances after broad-based, in-depth reforms over a decade.

Figure 14
Evolution of the vulnerability score



Source: ESM

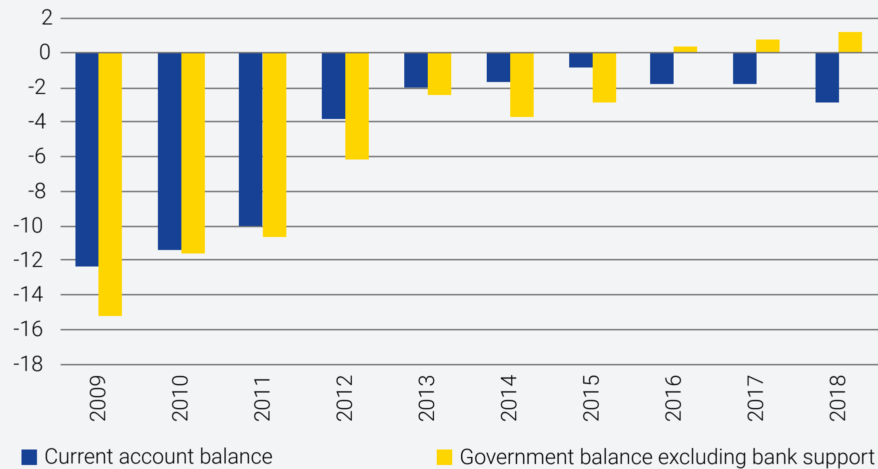
[8] Lennkh, R.A, Moshammer, E., and Valenta, V. (2017), *A Comprehensive Scorecard for Assessing Sovereign Vulnerabilities*, ESM, Working Paper 23, April 2017. https://www.esm.europa.eu/publications/comprehensive-scorecard-assessing-sovereign-vulnerabilities

"The euro is our currency. It is up to us, the ministers, the politicians, to agree and implement what is required for the common currency to be strong and credible. International recognition will follow."

MARTIN HELME

Minister of Finance, Estonia, ESM Governor

Figure 15
Improvement in fiscal and external balance
(in % of GDP)



Source: Eurostat

Fiscal consolidation paved the way to a balanced budget.

The government fiscal balance vastly improved from a 15.1% of GDP deficit in 2009 to surpluses since 2016. Greece's fiscal consolidation built upon a policy mix affecting both expenditures and revenues, notably through a series of reforms:

- Personal income tax:

  Harmonised and broadened tax base, integrated the solidarity surcharge into the personal income tax, and adjusted the tax rates over income groups with increasing progressivity. Further widening of the tax base and reduction of tax rates is legislated for 2020.

- VAT:

  Widened the base for the standard tax rate, increased tax rates, and limited reduced VAT regimes.

- Pensions:

  Lowered main and auxiliary pensions, streamlined eligibility criteria, and harmonised benefit and contribution rules.

- Public administration:

  Reduced public sector employment, wage and non-wage benefits for public servants, and rationalised the fragmented special wage grids.

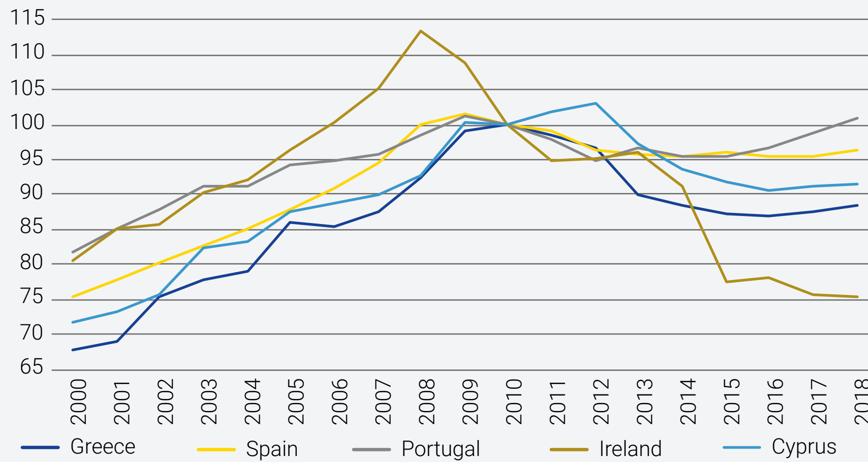
- Revenue administration:

  Established an Independent Authority of Public Revenue, improved tax collection by optimising tax audits, promoting and facilitating the use of electronic payments, and reducing corruption.

- Health system:

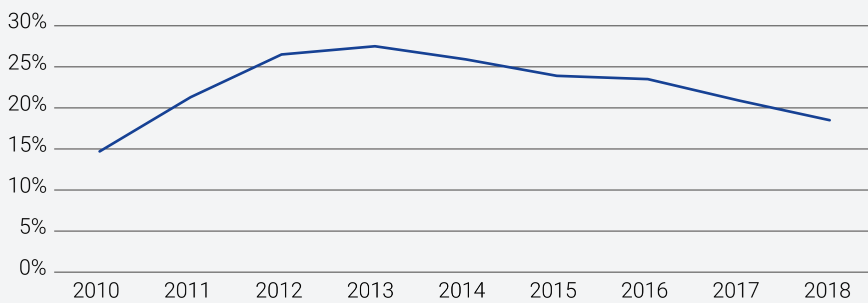
  Rationalised all off-patent drug prices, provided a claw-back mechanism for pharmaceuticals, and required diagnostic and private clinics to comply with spending ceilings.

Figure 16
Nominal unit labour costs
(2010=100)



Source: AMECO

Figure 17
Unemployment rate



Source: Eurostat

Labour market reforms – implemented mainly from 2010 to 2014 – reduced labour costs, removed rigidities, and introduced more flexible wage bargaining schemes (Figure 16). Further efforts helped to safeguard the opening clause in collective bargaining, allowing for rationalisation of the legal framework on dismissals and industrial action, tackling undeclared work, and strengthening active labour market policies. These reforms have contributed to job creation in recent years, reducing the unemployment rate from its peak of 27.8% in 2013 to 18.4% at end-2018 (Figure 17).

Labour costs decreased and the country's wage competitiveness improved.

Since 2008, Greece has lost almost a quarter of its GDP (Figure 18). Over recent years, however, output has stabilised and growth resumed in 2017 and 2018, with a positive outlook. Looking ahead, key reforms adopted throughout the programmes will translate into further output gains, supporting investment and exports. Reforms to improve the business environment focused on product markets and the privatisation of public assets and their improved management:

Output growth resumed with a positive outlook, thanks to productivity-boosting reforms.

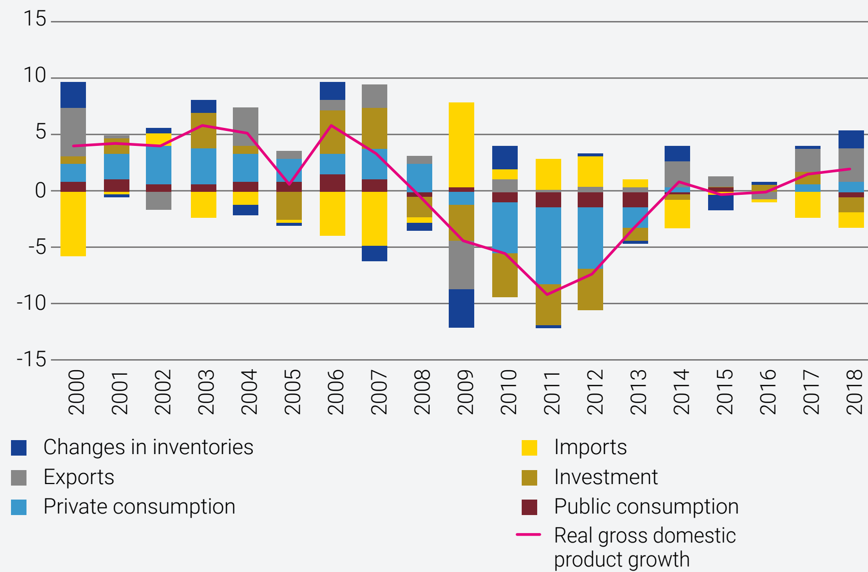
- Product market reforms:

  Implemented OECD competition toolkits, removed undue restrictions on regulated professions, facilitated setting up a business, removed barriers to entrepreneurship, simplified and modernised customs procedures and investment licensing procedures. As a result, between 2009 and 2019, Greece rose more than 30% on the World Bank's 'starting a business' indicator, and improved its score in the Global Competitiveness Index since a collapse in 2012. But Greece still ranks quite low versus its euro area peers and should continue implementation efforts.

- Privatisations and HCAP:

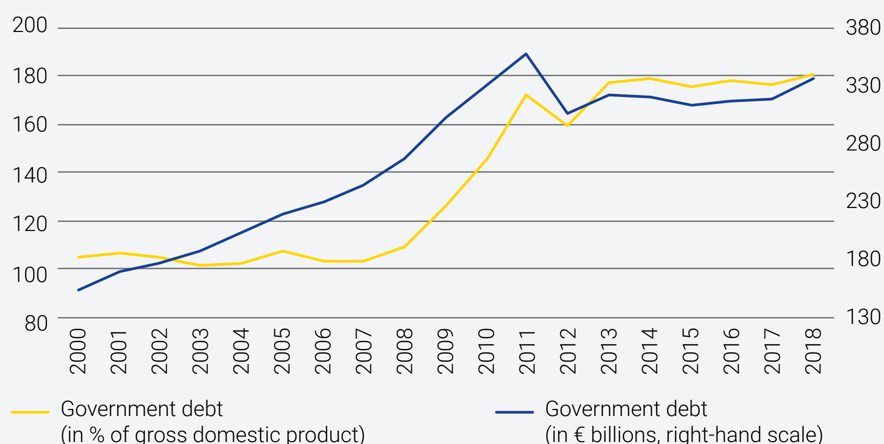
  Privatised a variety of public assets during the programmes to improve the efficiency of the economy, by shifting resources to the private from the public sphere. Concretely, the privatisations reduce the public cost of these assets, attract foreign investment, and enhance their contribution to the Greek economy. Despite delays in implementation, the privatisation programme has advanced and will continue during the post-programme period. Beyond this, Greece established a new structure, HCAP, to manage public assets, aiming to improve the quality of public services, enhance the value of public enterprises and real estate, and create revenue streams from them. Reforms in HCAP companies should strengthen Greece's corporate governance culture, generate funds for domestic investment, and support broader growth.

Figure 18
Real gross domestic product
(Growth in %, contributions in percentage points)



Source: Hellenic Statistical Authority (ELSTAT)

Figure 19
Government debt



Source: Eurostat

Safeguarding banking sector stability was crucial to the adjustment.

The Greek banking sector has undergone waves of stress leading to structural change. Four large banks control over 95% of the market as smaller players have been merged or liquidated. The four systemic banks have received three rounds of recapitalisation, 40% of which came from private investors, in 2013 to restore capital adequacy ratios from losses arising from the write-off of Greek government bonds and again in 2014 and 2015 to cover losses from the increase in NPLs. The banks also experienced large-scale deposit outflows, which made them reliant on emergency liquidity assistance and even required capital controls to safeguard financial stability. Deposit outflows peaked in 2012 and, after a short period of recovery, peaked again in 2015. Bank deposits stabilised in 2018, enabling the government to relax capital controls gradually. As part of the 2015 recapitalisation, Greece introduced strict rules to reform bank governance. The ongoing reforms are focused on legislation to reduce the NPL ratio, which remains the highest in the euro area, and generate new bank lending to support the recovery. Banks met NPL reduction targets up to the end of 2018, and have reduced the stock of NPLs by more than €20 billion since 2016.

Risks to debt sustainability have been broadly mitigated with several sets of debt relief measures.

Greece received substantial debt relief both from private creditors in 2012 and from the official sector in 2011, 2012, 2016 and, just before the end of the third programme, in June 2018. All these debt measures have improved debt dynamics (Figure 19). Greece's debt is expected to remain on a declining path, with gross financing needs below 15% of GDP in the medium term and below the 20% threshold in the long-term under the baseline scenario. European partners also committed to providing additional debt relief measures in 2032, if needed and provided that the EU fiscal framework is respected.

Challenges in the post-programme environment

Despite programme reforms, Greece faces key challenges to secure sustainable long-term growth.

Public finances need to remain on a sustainable path, while incorporating more growth-oriented policies. Already implemented or adopted reforms, such as the labour market reform and the lowering of income taxes in combination with a broadening of the tax base, need to be safeguarded and should not be reversed. In the event of court rulings overturning key structural reforms, the recurrent fiscal impact should be largely addressed by reforms within the same policy field. Further structural reforms are necessary to boost productivity and enhance competitiveness, complementing the country's growth strategy. These include reforms to make the economic environment more business friendly, reduce the time needed to resolve legal disputes, further improve the effectiveness of public administration while maintaining it at its current size, and enhance the efficiency of state-owned enterprises'

management. These institutional reforms, coupled with privatisations and improved management of state assets, are critical to attracting both foreign and domestic investment and strengthening future growth. Furthermore, Greece needs to support banks' efforts with a comprehensive NPL reduction strategy and improved legislative framework, which will help Greek banks' ability to lend to the economy and support the economic recovery.

The three financial assistance programmes for Greece

2010 2011 2012 2013 2014 2015 2016 2017 2018

FIRST PROGRAMME (I)

agreed in 2010

Initial programme amount: €110 billion

Total amount disbursed: €73 billion

Lenders: Euro area countries (except Slovakia) under Greek Loan Facility (GLF) managed by the European Commission: €52.9 billion; IMF: €20.1 billion

Grace period and maturity on GLF loans extended in 2012 to 10 and 30 years from 3 and 5 years, respectively

Interest rate: priced with Euribor 3-month with a margin lowered to 50 basis points from 300 basis points for GLF; IMF – around 3.96%

Key areas of legislated reforms: Pension system, healthcare system, public financial management, state budget, public sector benefits, labour market, closed professions

SECOND PROGRAMME (II)

agreed in 2012

Initial programme amount: €164.5 billion

Total amount disbursed: €153.8 billion

Lenders: EFSF: €141.8 billion (including €48.2 billion for bank recapitalisation, €34.6 billion for private sector involvement and bond interest facilities), of which €10.9 billion for bank recapitalisation was not used by the HFSF and was returned to the EFSF; IMF: €12 billion

Maximum weighted average maturity on EFSF loans initially extended in 2012 to a maximum 32.5 years from 17.5, finally extended to a maximum of 42.5 years in December 2018

Interest rate: Guarantee fee cancelled on EFSF loans, some interest payments initially deferred by 10 years and then extended to 20 years, up to 2032, and conditional waiver of step up interest rate margin on certain loan instalments; IMF: between 2.85% and 3.78%

Key areas of legislated reforms: Labour market, income tax, public administration, social protection, health system, public financial management, business environment

THIRD PROGRAMME (III)

agreed in 2015

Total amount committed: up to €86 billion

Total amount disbursed: €61.9 billion

Lenders: ESM: up to €86 billion (including up to €25 billion for bank recapitalisation); IMF: €1.6 billion approved in principal, but stand-by arrangement did not become effective

Maximum weighted average maturity: 32.5 years

Interest rate for cash disbursements: 1.45% (31 December 2018)

Key areas of legislated reforms: VAT, income tax, pension system, insolvency law, out-of-court debt workout, sales and servicing of loans (NPLs), public revenue collection, product markets, management of state assets, public administration, social protection

Spain

esm

The economy continued growing in 2018, outpacing euro area peers. However, there was some deceleration, stemming mostly from the external sector. Robust domestic demand helped to counterbalance the weak external environment. The general government deficit dropped below 3% mostly due to favourable cyclical conditions. As a result, Spain is expected to exit this year the Excessive Deficit Procedure for the first time since 2009. The Spanish treasury maintained good market access in 2018 and spillovers from Italian developments were limited and temporary. Spanish banks improved profitability and asset quality. The ratio of NPLs in Spain continued to decline towards the euro area average.

Spanish GDP grew by 2.6% in 2018, down from 3.0% in 2017. Domestic demand remained resilient, supported by a strong labour market and favourable financing conditions. Adverse global trade dynamics resulted in a negative contribution from the external sector. Spain recorded a current account surplus in 2018 for the sixth year in a row. However, the easing of external trade and an oil price recovery halved the current account surplus to 0.9% of GDP in 2018. The international debtor position reached an 11-year low at 77.1% of GDP. Inflation eased to 1.7% from 2.0% in 2017 driven by a lower contribution from both core and non-core components.

Employment growth remained solid at an average of 2.7% in 2018. The unemployment rate fell to 14.5% by year end, about half of its peak in mid-2013, but still remained well above the euro area average. The labour market recovery is not complete as unemployment remains high in some segments of the population, including youth.

The general government deficit dropped to 2.5% of GDP from 3.1% in 2017. Expenditure constraints and the cyclical upswing supported deficit reduction. Looking forward, the rejection of the 2019 draft budgetary plan may limit a faster rebalancing of public finances. The projected economic slowdown will also reduce past cyclical support to the deficit correction given a high structural deficit. Public debt remains high but has been on a declining trend over recent years, and stands at 97.1% of GDP in 2018.

Developments in Italy slightly affected Spain's government bond market last year, but spillovers proved to be temporary and contained. After peaking at about 1.7% in October, 10-year bond yields rallied to around 1.4% by year-end, and the spread versus Germany ended the year broadly unchanged compared to end-2017. Spain retained good market access and raised €132 billion in medium- and long-term debt in 2018, above its initial €126.3 billion target. On the other hand, Spain reduced its net issuance to €34.3 billion from €40 billion. All major rating agencies upgraded Spain in 2018.

Spanish banks improved profitability and asset quality, helped by the recovery of the economy and the real estate market. This allowed banks to sell a large amount of non-performing assets during 2018. Domestic profitability and NPL ratios improved, edging closer to the euro area average. When including business abroad, Spanish banks have better NPL and return on equity ratios than the euro area. The decrease of the overall credit stock in Spain eased, because credit to households increased in the 2018 third quarter for the first time since the crisis. Banks' capital buffers are adequate, but capital ratios remain below the euro area average.

Spain created a macro-prudential authority and empowered Spanish financial supervisors with additional macro-prudential tools. The deadline to divest Bankia has been extended until December 2021. The merger of Bankia and Banco Mare Nostrum was completed in January 2018.

Under its Early Warning System, the ESM continued to assess positively Spain's ability to honour its ESM loan service repayments. In 2018, Spain made an additional three voluntary repayments of €8 billion in total, leaving the ESM outstanding loan at €23.7 billion. Early repayments give a strong positive signal to the market about the success of the Spanish financial assistance programme and also reinforce the position of the ESM, as a mature institution that successfully supported countries during a crisis. Given high public debt levels, a credible fiscal strategy and stronger reform momentum are key to reducing the vulnerability to adverse shocks going forward.

Cyprus

esm

Cyprus regained an investment grade rating in 2018 thanks to strong economic growth, a prudent fiscal policy, and a more resilient financial sector. The winding down of Cyprus Cooperative Bank (CCB) alleviated a major risk to financial stability through the removal of a large share of NPLs from outside the banking sector. This one-off operation, however, adversely affected public finances in 2018 and banks still remain burdened by a sizeable NPL stock. Sustained reform momentum is key to mitigating the domestic and external risks that could unravel efforts made over recent years.

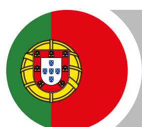
The Cypriot economy posted another consecutive year of strong growth. GDP grew close to 4% in 2018, primarily driven by private consumption. Productivity growth reached the pre-crisis level, reflecting efforts to remove barriers in the service market. Economic activity helped to reduce the unemployment rate to close to 8%. Yet Cyprus' economy remains exposed to external risks, which may lead to a sharper-than-expected slowdown of GDP growth that could, for example, reduce tax receipts and put a halt to the downward trend of unemployment.

Excluding the CCB transaction and its one-off impact on public finances, a combination of favourable economic conditions and prudent fiscal policy kept public finances on the virtuous path. The Commission projects that the general government surplus should still exceed 2.5% of GDP in the medium-term. The government's support of the CCB partial sale temporarily interrupted the reduction of public debt, which had fallen below 100% of GDP at the end of 2017. The CCB deal will also lead to increased financing needs in the coming years. Cyprus currently faces no major risks in meeting its loan service payments. The reform momentum should, however, continue, particularly in areas related to public administration law.

Cyprus' banks made important progress, but the sector remains vulnerable. NPL ratios in the banking sector declined significantly but remain among the highest in Europe. In 2018, several NPL portfolio sales took place. Banks advanced in their restructurings but suffer from low profitability and additional provisioning pressures. Furthermore, the government adopted a three-pillar strategy to stabilise the sector and reduce NPLs. A crucial pillar was the CCB's orderly market exit. A domestic competitor acquired parts of CCB's assets and liabilities, while another state-owned entity is gradually reducing the former CCB NPL stock. The second pillar was the strengthening of the legal framework for insolvency, foreclosures, and asset disposals as well as the adopting of a securitisation law. The third pillar, an NPL subsidy scheme with pre-defined eligibility criteria, supports borrowers who face difficulties repaying loans backed by their primary residence.

The strong economic performance and the accelerated clean-up of banks' balance sheets led to several rating upgrades. Cyprus now enjoys an investment grade rating from three of the four major agencies, and sovereign bond yields declined substantially during the year. Taking advantage of these developments, Cyprus issued a 10-year bond at a yield of 2.4% in September 2018. Going forward, the high private and public debt levels will remain the major burden on the country's creditworthiness.

Despite Cyprus' solid recovery in recent years, the country needs to safeguard the robust fiscal performance to relieve the public debt burden. And while the financial sector has made important progress, the high level of NPLs remains a key vulnerability for banks.



Portugal

EFSF

Portugal's economy continued growing, with some deceleration stemming mostly from the external sector. Domestic demand was the main driver of growth supported by improvements in the labour market. By the end of 2018, fiscal targets were met, supporting reductions in high public debt. This downward debt trajectory remains susceptible, however, to lower-than-expected growth dynamics and to a drag on public finances from an ageing population. The health of the banking system improved, but vulnerabilities remain, such as NPLs above the euro area average and weak profitability.

GDP growth moderated to 2.1% in 2018 from 2.8% in 2017 due to weaker global and euro area growth. Gross capital formation and private consumption were the primary drivers of growth. Net exports' positive contribution was interrupted in 2018; import growth outweighed that of exports, given a weaker contribution from tourism. Labour market developments were positive with unemployment stabilising at 6.6% by the end of 2018. Growth is expected to decelerate gradually between 2019 and 2021, caused by a moderate slowdown of private consumption and business investment. Trade disputes and Brexit could also impact future economic developments.

The general government budget deficit reached 0.5% of GDP in 2018, improving beyond the 0.7% target, following revenue outperformance and contained expenditure growth. Both current revenues and primary spending grew in line with the annual targets. The public debt level declined further to 121.5% of GDP in 2018 from 124.8% of GDP in 2017 in response to improvements in the primary balance. Moreover, fiscal performance and good market access allowed Portugal to repay early and in full its IMF loan and further smooth its debt maturity profile, taking advantage of the current low rates. Portugal has also committed to an early repayment of the EFSF loan by up to €2 billion from 2020 to 2023 subject to market conditions and the impact on debt sustainability as assessed at the time.

In 2018, Moody's was the last of the major rating agencies to upgrade Portugal's rating to investment grade taking into account positive economic developments. The 10-year government bond yield returned to the 1.5%-2% range in the second half of 2018, close to the historical lows after the end of its programme, following some temporary volatility in the first half of the year. The spread to Germany has also been broadly stable around 150 basis points.

Economic growth, higher real estate prices, and heightened investor interest supported the banking sector's continued recovery in 2018. The sector's profitability improved clearly in 2018 compared to previous years. The NPL ratio dropped significantly by 3.9 percentage points during 2018 to 9.4%. NPL sales and cures have driven the fall in the NPL stock. The total capital ratio remained constant at 15.2% of risk-weighted assets, while the common equity tier 1 ratio decreased slightly to 13.2%. The resolution fund is liable for future losses of Novo Banco through a capital contingent mechanism until 2025. In 2018, Novo Banco made use of it and received its first payments from the resolution fund, which were partially funded by a state loan.

The continued assessment of Portugal's repayment capacity suggests no short-term repayment risk of the outstanding EFSF loan. Portugal's high public debt burden, however, remains an important vulnerability and its downward trajectory remains fragile due to weaker growth, fiscal fatigue, and the ageing population. Prudent fiscal policies and structural reforms should, therefore, be pursued to boost long-term growth and increase resilience to shocks. The impact of expansionary policies, such as the resumption of civil servant promotions and the respective salary increases or minimum wage increases, needs to be carefully monitored. While on a consistent downward trend, the still high level of NPLs in the banking sector and weak profitability represent the main challenges in the financial sector looking forward.

Resilience of countries that benefited from financial assistance

Spillovers, or contagion, raised the cost of the crisis for the euro area.

A key challenge in the euro area debt crisis was contagion: stress in one member state affecting financial markets in another. Tensions spread as investors demanded a higher risk premium to hold the government bonds of even those Member States not directly affected by the initial shock. In other words, contagion increased the costs of the crisis for the euro area.

During the crisis, in extreme cases, investors priced in some risk of a country exiting the euro area.

Given the characteristics of spillovers in a currency union, contagion may also have been driven by markets' perception of redenomination risk: the risk that a financial asset is converted from one currency into another of lesser value. In the euro area, this could be understood as investors' perception of the risk that a member state introduces a parallel currency or, in an extreme case, leaves the currency area. This can have implications for other Member States and raise the risk of contagion, but appropriate policies can mitigate this risk.

Since the crisis, however, these fears, and contagion, have receded.

Former programme countries have become less affected by such external shocks, demonstrating the results of the reforms carried out during the programmes. Despite volatility in European sovereign debt markets in 2018, the spillovers to former programme countries were relatively limited compared to previous episodes of market stress. Contagion, and investors' perceptions of redenomination risk, have been contained.

Contagion risk

We compare 2016–2018 to the start of the crisis period, 2009–2011.

One way to look at the extent of contagion is to assess the correlation of asset prices. Methodologies range from simple correlations to more complex econometric techniques.[9] Here, we present the simple correlations across sovereign credit spreads of selected countries, and two measures of redenomination risk. Due to data limitations, we focus on three Member States that benefited from financial assistance (Ireland, Spain, and Portugal) and relate them to two major euro area economies that experienced some market volatility over the past two years (France in 2017 and Italy in 2018). We compare two three-year windows: the crisis period (2009–2011) and recent years (2016–2018).[10]

Over the long-term, post-programme countries' bond spread developments appear to have aligned more with the country having steadier spreads.

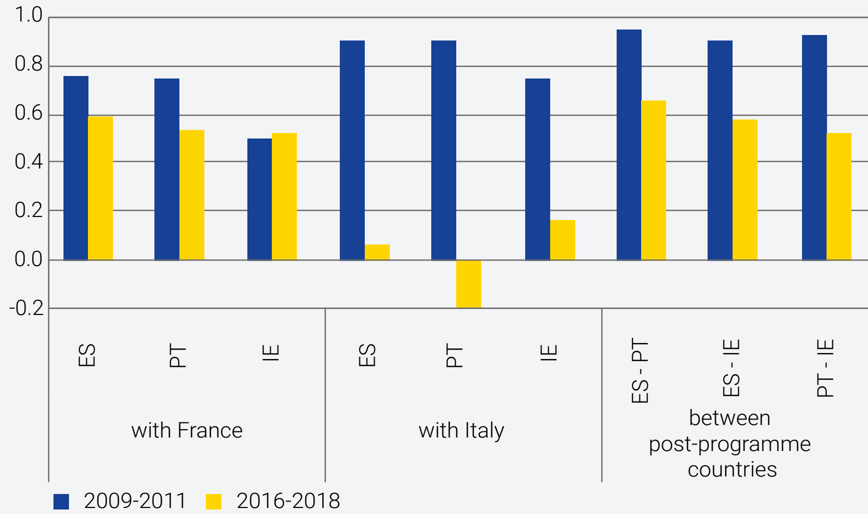
Based on this simple exercise, it appears that the sovereign credit spreads of the three post-programme countries have become less vulnerable to external developments. Figure 20 depicts the one-on-one (pairwise) correlation of sovereign credit spreads of each of the three post-programme countries to France and Italy, respectively, as well as between each pair of the three post-programme countries. It shows that the three countries' spread levels, which reflect country-specific risk premia, demonstrated higher correlation with Italy than with France during the crisis period, but that the correlation with Italy weakened in the recent three-year window.[11] In other words, the spreads of the three countries were more highly correlated with France than with Italy in the recent period. This development can be interpreted as a sign of improved resilience of the three post-programme countries to external developments (Figure 21).

[9] See, for example, Martin Hillebrand et al., *European government bond dynamics and stability policies*, ESM Working Paper 8, 2015. For recent overviews of other measures of contagion by market analysts see, for example, Clemente De Lucia et al., Contagion: Italy and the role of fiscal similarity, Deutsche Bank, 12 November 2018; and Matteo Crimella, Moderate Spillover from Italian Turmoil, Goldman Sachs, 1 June 2018.

[10] We use 10-year government bond yields compared to Germany as a benchmark, in line with common practice. We exclude 2012 from the crisis period sample, due to structural breaks such as the Greek private sector involvement and the announcement of the ECB's outright monetary transactions instrument.

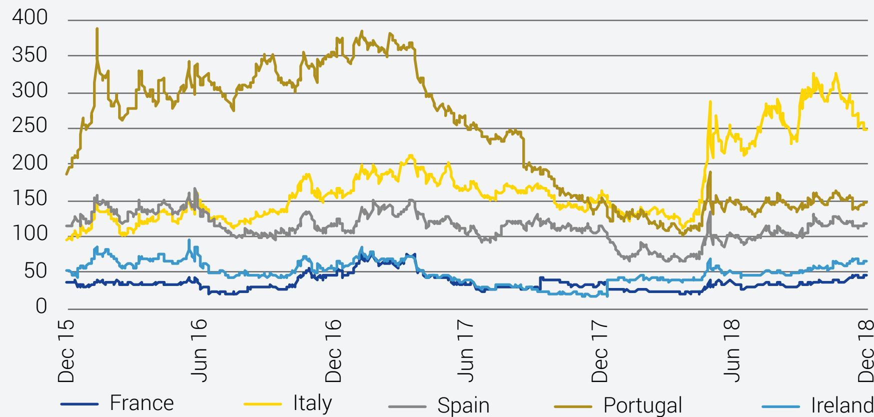
[11] The correlation of sovereign credit spreads between Italy and Portugal over the entire 2016–2018 sample turned marginally negative due to Portugal's return to investment grade rating in 2017.

Figure 20
Correlation of 10-year sovereign credit spreads



Notes: We use a relatively long three-year correlation window to ensure more stable results. Data for Ireland is up to October 2011 in the first window.
Sources: ESM based on Bloomberg data

Figure 21
10-year sovereign credit spreads vs Germany
(in basis points)



Source: Bloomberg

Correlations between each pair of the three post-programme countries also declined somewhat compared to the crisis period. This may signal that investors have a greater focus on country-specific factors and differentiate more between these countries. The short-term liquidity and volatility of these markets may still be correlated, but it appears that longer-term trends have become more idiosyncratic. This is a welcome development, which can also help to reduce the risk of contagion.

Investors also appear to be focusing more on country-specific factors.

Redenomination risk

The market perceptions of redenomination risk can be derived from financial instruments. De Santis (forthcoming)[12] proposed a redenomination risk measure based on the difference between credit default swaps (CDS) issued in US dollars and those

Financial instruments can provide insight into investor perceptions of the risk a country might leave the euro area.

[12] Roberto A. De Santis, Redenomination risk, *Journal of Money, Credit and Banking*, forthcoming.

in euros, the quanto-CDS. This difference reflects the insurance against the risk of euro devaluation or the introduction of an alternative currency. Under normal circumstances this is close to zero, but it can increase in times of market stress. Market perceptions of country-specific redenomination risk can be computed by taking the country's quanto-CDS spread relative to the German quanto-CDS, as the sovereign bonds of Germany are rated AAA by credit rating agencies and hence likely considered relatively safe by investors.[13] Yet we note that the use of CDS as an instrument to derive redenomination risk has to be handled with care, given the limited liquidity and transparency of the market.[14]

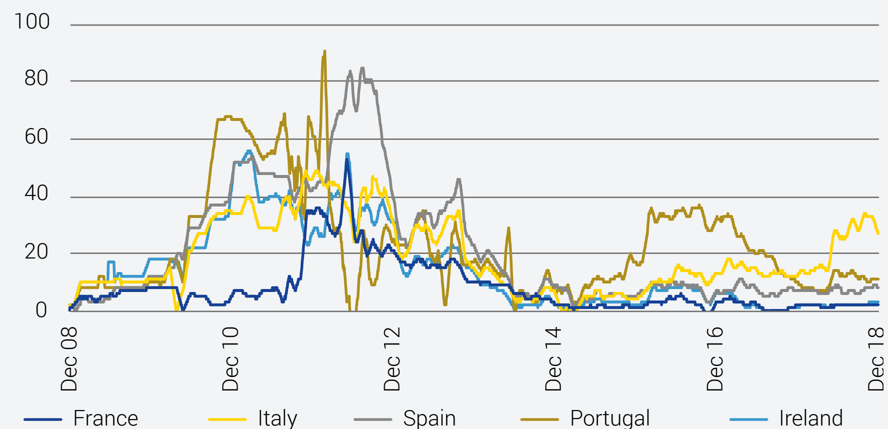
Perceptions of such risk declined substantially after 2012.

Figure 22 depicts the quanto-CDS spreads for the five countries in our sample since 2009. It shows that the perception of redenomination risk by markets increased more broadly during the euro area debt crisis, but that spillovers have dampened in recent years. Consistent with these observations, a recent academic paper covering a broader sample also finds that redenomination-risk spillovers are muted for most euro area member countries, and the number of those exposed to such risks declined after 2012.[15]

Post-programme countries have been less affected by such shocks recently.

Another measure of redenomination risk also corroborates these findings. Gros (2018)[16] suggested that market perceptions of redenomination risk could also be measured by comparing the spread between different CDS vintages: CDS contracts issued under the 2003 International Swaps and Derivatives Association (ISDA) convention did not explicitly refer to redenomination as a credit event, but CDS contracts based on the new 2014 documentation provide stronger protection against such risk. Hence the difference between the two types of contract may point to investors' concerns about redenomination risk.[17]

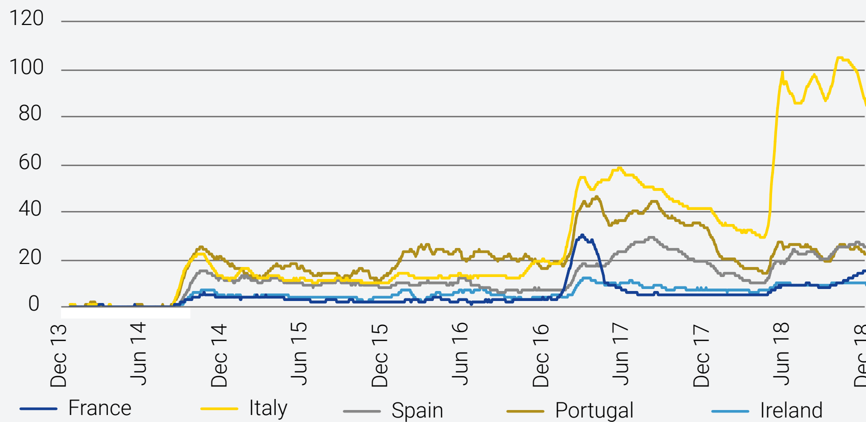
Figure 22
Quanto-CDS spread, 20-day moving average
(in basis points)



Note: The chart is based on daily data of 5-year CDS contracts.
Source: Thomson Reuters Datastream

[13] Germany is the common benchmark for the euro area sovereign debt market, and the use of countries' quanto-CDS relative to Germany rests on the idea that such a spread would be close to zero if the market perceives the risk of a euro area break-up as negligible. For further details, see pp. 8 and 15 in Roberto A. De Santis, A measure of redenomination risk, *ECB Working Paper* 1785, April 2015.
[14] With respect to quanto adjustment, one has to be also aware that the majority of traded CDS contracts are USD-denominated and the EUR-denominated contracts are less liquid.
[15] Nicola Borri, Redenomination-risk spillover in the eurozone, *Economics Letters* 174 (2019), pp. 173–178.
[16] Daniel Gros, Italian risk spreads: Fiscal versus redenomination risk, VoxEU.org, 29 August 2018.
[17] The spread between the ISDA 2003 and 2014 CDS definitions are wider than the quanto-CDS spread, because it captures not only redenomination risk but also provides stronger protection to sovereign bond holders more broadly. Since the CDS 2003 definitions are perceived to be less effective in hedging some risks, such as the redenomination risk, potential buying pressure is concentrated on the 2014 contracts, partly explaining the asymmetry in the relative price movements. Hence caution is warranted when translating these numbers into proportions as to what extent redenomination risk specifically can explain the widening of sovereign credit spreads.

Figure 23
Spread between different CDS vintages, 20-day moving average
(in basis points)



Note: The chart is based on daily data of 5-year CDS contracts.
Source: Thomson Reuters Datastream & CMA Datavision via Haver Analytics

As shown in Figure 23, redenomination risk has been repriced around political events. Although data for this measure have become available only in the last few years, they nonetheless cover events such as the French elections in 2017, and the government formation in Italy last year. In line with the pattern shown by simple correlations and the quanto-CDS metric, it appears that the three post-programme countries have been less affected by external shocks recently.

Other metrics and research results also support this conclusion.

Drivers of resilience

Spillovers across markets have declined since the crisis…

Overall, spillovers across markets have been reduced since the crisis period, due to European policy initiatives and Member States' own efforts.

…because euro area fundamentals are more robust than before the crisis…

First, there are sound macroeconomic reasons for the more limited spillovers: euro area fundamentals are now more robust than before and during the debt crisis years, particularly in former programme countries. Domestic efforts supported by adjustment programmes reinforced Member States' ability to weather external shocks.

…while low interest rates and ECB programmes may have softened the impact of external shocks.

Second, the strengthening of the euro area stability framework has been instrumental in reducing contagion risk. Markets considered the creation of the ESM and the introduction of the ECB's outright monetary transactions instrument, for example, as key innovations to defuse tensions in sovereign debt markets.[18] Other institutional reforms, such as enhanced banking supervision and fiscal rules, also play a vital role in ensuring the euro area's stability.

Third, historically low interest rates and the presence of the central bank in government bond markets through the ECB's public sector purchase programme (PSPP) may also have dampened the impact of external shocks.

Work towards stronger fundamentals and an even more robust EMU framework should continue to cement these achievements.

The combination of these factors helped to contain the market impact of policy uncertainties in some Member States, and ensured that these remain idiosyncratic rather than systemic. Furthermore, with contagion risk reduced, investors also seem to have a greater focus on country-specific factors and differentiate accordingly. Nevertheless, contagion has decreased but not disappeared, and hence there is no room for complacency: it is imperative to continue the work towards stronger macroeconomic fundamentals and a more robust institutional framework by deepening EMU.

[18] See, for example, George Cole and Matteo Crimella, EMU Bonds Resilient to Italy Risks...But Watch Growth, Goldman Sachs, 24 October 2018.

"Strengthening the global role of the euro consolidates its global economic and trade influence and reflects the euro area's political, economic, and financial significance. This is appropriate as our work on completing Economic and Monetary Union continues, including creating a deeper and more stable European financial sector."

PASCHAL DONOHOE

Minister of Finance and Public Expenditure and Reform, Ireland, ESM Governor

02 ESM activities

Processing the financial transactions of the ESM

The ESM engages in substantial financial operations daily. The Middle and Back Office division performs a vital role in validating and processing these transactions.

The Middle and Back Office supports three teams: ALM and Lending, which monitors liquidity risk and manages the outstanding loans to programme countries; Funding and Investor Relations, which raises the money to finance lending operations; and Investment and Treasury, which manages the paid-in capital of €80.5 billion,[19] the reserve fund, and the liquidity buffer.

The Middle Office embeds risk management and control procedures in its transaction processing. The Back Office ensures that securities and financial instruments are bought or sold for the correct amount of money, at the appropriate time, and with the right counterparty. It also transfers the money.

[19] As at 31 December 2018.

ALM and Lending

The Middle Office helps to draft lending documents for disbursement, verifies the accurate recording of loan details in the system, and provides invoices for all financial assistance programme countries. The Back Office executes disbursements and subsequently monitors in- and outflows to and from programme countries.

Funding and Investor Relations

Once Funding issues a security, the Middle Office validates the trade. Then the Back Office confirms that the trade details match those of the purchasing institutions. Finally, the Back Office ensures that the trade is correctly delivered.

Investment and Treasury

Once Investment initiates a trade, the Middle Office validates it, ensuring details are correctly recorded, and investment limits are respected. The Back Office then instructs an external provider to settle the trade. The Middle and Back Office each have separate post-trading activities to make sure trades are correctly executed.

As part of the Middle Office, the portfolio performance team supports Investment and Treasury, the investment management committee, and other functions through performance measurement, appraisal, attribution, and maintenance of benchmark portfolios.

Together with Middle and Back Office, the Coordination team and the Commercial Legal and Procurement team constitute the department: Middle & Back Office and Portfolio Performance, Coordination and Commercial Legal and Procurement.

Coordination

The Coordination team drives change across the ESM through project management and business analysis. It leads the ESM's strategic planning and contributes to the continuous improvement of the organisational planning cycle. It hosts the outsourcing committee and oversees the implementation and further development of the outsourcing policy.

In 2018, the Coordination team organised the technical assistance mission to Greece and finalised the definition of the ESM's functional model, the first pillar in the institution's overall operating model. The functional model influences, in particular, sourcing decisions, IT strategy, and human resource management. The Coordination team also led and/or contributed to a number of internal projects including the introduction of new products, improved risk management and portfolio performance, records management, and operational improvements.

Commercial Legal and Procurement

The Commercial Legal and Procurement team supports the fulfilment of the ESM's operational needs in line with the strict standards of the ESM procurement policy. Created at the start of 2018 with the merger of two teams, the new unified team supported several key procurement procedures and contracts, including for a Risk Management and Portfolio Analytics Software and a critical upgrade to the ESM's SWIFT infrastructure. The team also introduced a planning tool and an information portal, standardising and automating various internal processes. In addition, the team started using the Eurosystem Procurement Coordination Office (EPCO), enabling the ESM to procure at better commercial terms due to economies of scale.

ALM and Lending activities

- The ALM team participated in the completion of the interest rate risk reduction programme for Greece and continued to improve the liquidity management framework.
- The Lending team implemented the final year of the three-year financial assistance programme to Greece, which concluded in August 2018.
- Spain made three additional voluntary early loan repayments in 2018.

Asset and Liability Management

ALM's role is to measure, monitor, and manage the liquidity, currency, and interest rate mismatches between assets and liabilities that may arise from the execution of the ESM and EFSF mandate.

In 2018, the ALM and Funding teams jointly completed a hedging programme under the interest rate risk reduction measures for Greece. In this process, the ESM took into account the last disbursements to Greece under its financial assistance programme. For more information on this topic, see 'Greek programme achievements' and the Greek country section.

In line with the Eurogroup's guidance, the team also adapted the ESM's financial framework so the reduction measures did not alter interest rates charged to other beneficiary Members. The team reinforced operational controls and the hedging programme is now in a maintenance phase.

Because the ESM hedges interest rate risk for Greece and made a second issuance in US dollars, the ALM team also further improved the ESM's liquidity management framework. In September 2018, the liquidity management framework was amended to allow the ESM to place available cash in its ECB account. The ECB charges interest on this cash and the income this generates is spread among euro area countries, according to the capital key.

Lending

Conclusion of the ESM Greek programme

As of the end of August 2018, the ESM Greek programme successfully concluded and the ESM had disbursed €61.9 billion in financial assistance, 72% of the original €86 billion committed under the August 2015 agreement with Greece. As a consequence of the expiration of the availability period on 20 August 2018, the remaining €24.1 billion is no longer available for disbursement.

The ESM made three disbursements to Greece in 2018 totalling €21.7 billion, all in cash. Of these, €8.8 billion was used for debt servicing, €1.5 billion was dedicated to net arrears clearance, while the remaining €11.4 billion contributed to the building up of a cash buffer. The amounts disbursed in 2018 must be repaid from 2034 to 2060.

"To strengthen the euro we need to strengthen the eurozone. So before putting the cart before the horse, we need to proceed at a quicker pace with finishing the process of banking union, establishing a mechanism to deal with regional inequalities, and much more besides."

EUCLID TSAKALOTOS

Minister of Finance, Greece,
ESM Governor

Table 1
ESM disbursements to Greece

Disbursement	Disbursement date	Loan amount (in € billion)		
		In kind	In cash	Cumulative
1st tranche, sub A, disbursement 1	20/08/2015		13	13
1st tranche, sub A, disbursement 2	24/11/2015		2	15
1st tranche, sub B, disbursement 1	01/12/2015	2.72		17.72
1st tranche, sub B, disbursement 2	08/12/2015	2.705		20.425
1st tranche, sub A, disbursement 3	23/12/2015		1	21.425
2nd tranche, disbursement 1	21/06/2016		7.5	28.925
2nd tranche, disbursement 2	26/10/2016		2.8	31.725
3rd tranche, disbursement 1	10/07/2017		7.7	39.425
3rd tranche, disbursement 2	30/10/2017		0.8	40.225
4th tranche, disbursement 1	28/03/2018		5.7	45.925
4th tranche, disbursement 2	15/06/2018		1	46.925
5th tranche	06/08/2018		15	61.925
Total		**5.425**	**56**	**61.925**

Source: ESM

The ESM, as reported in the *ESM 2017 Annual Report*, received an early repayment of approximately €2 billion from Greece in February 2017, after one bank that had been recapitalised with contingent convertible bonds returned those funds to Greece in December 2016. This triggered an early repayment right for the ESM that it exercised in February 2017, reducing the loan outstanding to €59.9 billion from €61.9 billion. In March 2018, the ESM Board of Directors approved the amendment of the Financial Assistance Facility Agreement with Greece, adding the HCAP, a new fund established as part of the ESM programme, into the lending structure.

In the course of the year, the Lending team also contributed to finalising the design and preparing the implementation of the medium-term debt measures for Greece, which were endorsed by the Eurogroup in June 2018.

Spain makes another three voluntary prepayments

In October 2018, Spain executed the ninth voluntary early repayment of loans under its bank recapitalisation programme for €3 billion, following the ESM Board of Directors' approval. Earlier in the year, in February and May 2018, Spain carried out the seventh and eighth voluntary early repayments of €2 billion and €3 billion, respectively. At the end of 2018, the total outstanding amount of the ESM loan to Spain was €23.72 billion, out of a total €41.3 billion disbursed from an initial programme amount of €100 billion.

Spain had previously voluntarily prepaid €2 billion in November 2017, €1 billion in June 2017, €1 billion in November 2016, €2.5 billion in July 2015, €1.5 billion in March 2015, and €1.3 billion in July 2014. It also made a scheduled repayment of €0.3 billion in July 2014.

Table 2
Total budget savings for all programme countries
(in % of GDP)

	2011	2012	2013	2014	2015	2016	2017	2018
Ireland	0.1	0.3	0.3	0.3	0.3	0.3	0.3	0.2
Greece	0.0	1.6	4.1	5.0	5.2	6.2	6.6	7.0
EFSF	0.0	1.6	3.7	4.3	4.4	4.7	5.0	5.0
Deferred interest	0.0	0.0	0.4	0.7	0.7	0.7	0.6	0.7
ESM	0.0	0.0	0.0	0.0	0.2	0.8	1.1	1.3
Spain	0.0	0.0	0.2	0.2	0.2	0.2	0.2	0.1
Cyprus	0.0	0.0	0.7	1.6	1.9	2.0	2.0	1.9
Portugal	0.1	0.4	0.6	0.7	0.7	0.7	0.7	0.7

Note: The ESM estimates these savings by comparing the effective interest rate payments on ESM and EFSF loans with the interest payments these countries would have paid had they covered their financing needs in the market. First, we estimate the direct budget savings per disbursement by comparing the ESM and EFSF rate to the 10-year bond yield, used as a proxy long-term market rate. We apply a cap of 6.4% on market rates, which from experience of the crisis suggests significant market stress and imminent loss of market access. Second, we calculate the indirect benefits. For each disbursement, the ESM calculates the gains from the previous year's reduced financing needs, making the same market rate assumptions as for direct budget savings.

Sources: ESM calculations based on ECB and Eurostat data

Funding and Investor Relations

- The ESM's Greek programme drew to a successful close in August 2018, ending all the rescue funds' active programmes entered into since 2012, but the EFSF and ESM will remain present in debt markets for future decades rolling over debt related to the rescue loans.
- The ESM issued its second dollar bond, a 2-year, building its strategic presence in the dollar market.
- The ESM further diversified its investor base in 2018, attracting 60 new investors to its issues.

The year 2018 was a milestone for the ESM with the end of the programme for Greece in August. For the first time in the ESM's history, there are no new loan disbursements to finance. Since the programme's conclusion, investors have often asked whether the EFSF/ESM will continue the funding programme.

The answer is, of course, 'yes'. While the loan disbursements have stopped, the EFSF and ESM will need to manage the rollover of their combined, approximately €300 billion in existing debt. The bonds issued have an average maturity of eight-to-nine years. In comparison, the outstanding average maturity of all EFSF and ESM loans combined was about 23 years at end 2018. Because of the mismatch between bond and loan maturities, until all the loans have been repaid, the ESM and EFSF will have to roll over maturing bonds – expected to run at a pace of some €30 billion a year for the coming years. The EFSF and ESM will therefore remain significant issuers of debt for many years to come, continuing the diversified funding strategy, which includes:

- New benchmark euro bonds across the yield curve
- Reopenings of existing bonds
- Strategic presence in the dollar market
- Regular bill programme
- N-bond programme

To fulfil its mission, the ESM must always be ready to raise large amounts on the debt capital markets should the necessity arise. It must therefore ensure it has a significant market presence and continue its funding strategy, which aims to provide opportunities for a variety of investors across a wide range of instruments.

Funding programme

In December 2017, the combined funding for the ESM and EFSF was announced to be €51 billion for 2018.

- €23 billion for the ESM
- €28 billion for the EFSF

On 8 February 2018, the ESM Board of Directors approved an early repayment by Spain of €5 billion. Of this total, €2 billion was repaid on 23 February and the remaining €3 billion in May. The ESM fund-

"For more than 300 million citizens, the euro is the most tangible symbol of what we can achieve when working together. Completing the banking and capital markets unions and, in the longer term, a European safe asset, will underpin confidence in our common currency for the benefit of our citizens and global financial stability."

NADIA CALVIÑO

Minister for Economy and Business, Spain, ESM Governor

ing target was consequently reduced to €18 billion from €23 billion and the combined funding target to €46 billion from €51 billion. Spain made a further voluntary repayment of €3 billion in October, which was digested by the ESM's liquidity management and did not impact the ESM funding programme.

To finance rollover needs, the combined funding for the EFSF and ESM in 2019 will be €32.5 billion.

- €10 billion for ESM
- €22.5 billion for EFSF

Market environment

The ECB announced the end of the net purchases for the asset purchase programme in December 2018, prompting considerable discussion with investors about the potential consequences for the ESM.

Quantitative easing had reassured investors that the ECB was ready to purchase bonds in the secondary market. Investors such as asset managers and hedge funds who like to regularly buy and sell bonds, had been placing large orders for ESM bonds comfortable in the knowledge that they could easily sell them on the secondary market to the ECB. Yet, while the net purchases of the PSPP may have drawn to a close, the principal reinvestment needs are relatively high, and the ECB will still be present as a buyer on the secondary market. While the large ECB buy orders seen during the active PSPP period may decrease, the PSPP will, therefore, still continue to support the market in 2019, albeit to a lesser degree.

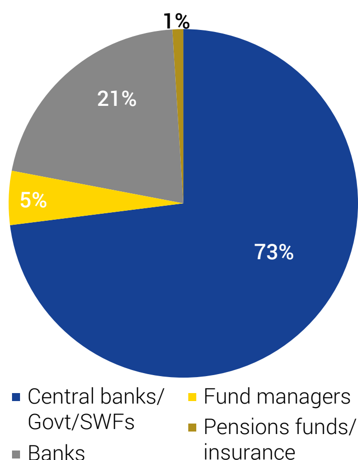
On the positive side, the end of net asset purchases brought wider spreads for our bonds and Sovereign, Supranational and Agency (SSA) bonds in general versus swaps and government bonds. From an investor point of view, this is very good news. Especially those investors like bank treasuries that tend to hedge their investments with swaps, or those who are benchmarked versus government bonds, took advantage of the attractive levels. As a consequence of the wider spreads versus swaps, the yields of our bonds at the short end became less negative. This allowed the ESM to issue a 3-year bond in October, the first bond it has issued in this maturity for over three years.

ESM bond issuance

The ESM funding team raised the planned €18 billion through the issuance of four new euro bonds, three re-openings of existing euro bonds, and the launch of the ESM's second dollar bond. Bonds were spread across the yield curve ranging from the 3-year bond in October to the reopening in August of a 40-year bond issued in 2016.

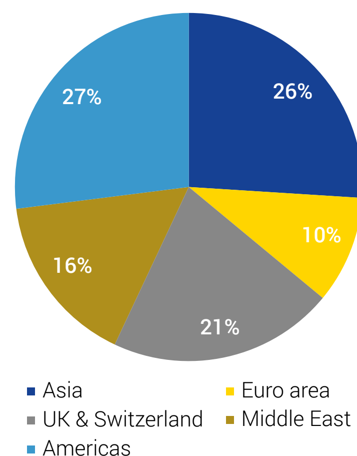
As part of the strategy to widen its investor base, the ESM issued its first dollar bond in October 2017. The following October, it launched a second dollar bond, a 2-year. Central banks purchased an exceptionally high 73% (Figure 24). The ESM successfully diversified its investor base (Figure 25), attracting the participation of seven new investors and 10 new subsidiaries of existing investors.

Figure 24
ESM 2-year dollar bond issue breakdown, by investor type



Source: ESM

Figure 25
ESM 2-year dollar bond issue breakdown, by geography



Source: ESM

ESM bill issuance

The ESM held regular 3- and 6-month bill auctions in 2018, continuing the bill programme launched in January 2013. The bill market is an important tool to diversify the funding source and investor base. The ESM therefore keeps a minimum presence to ensure permanent access to this investor base. If liquidity needs were to rise, the ESM could increase the bill volume to limit oversupply on the bond curve.

Since inception, the ESM has conducted 138 3- and 6-month bill auctions, raising more than €245 billion.

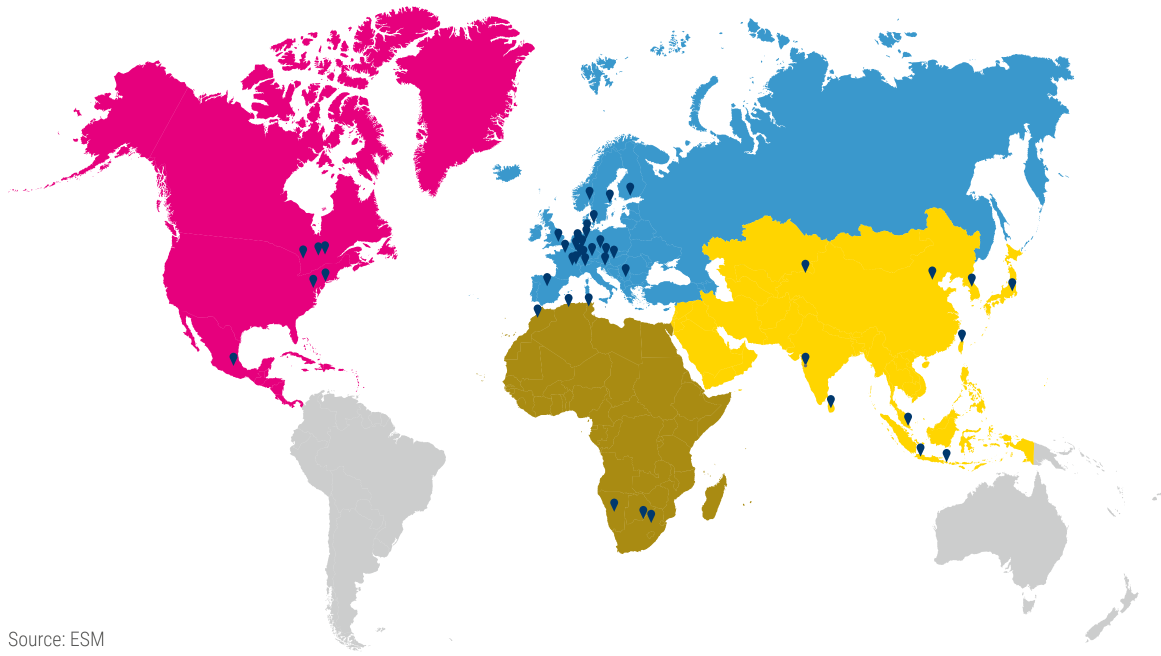
Best supranational euro deal of the year

In December 2018, the capital markets publication Global Capital awarded the ESM with 'Best Supranational Euro Deal of the Year', recognising the €4 billion 5-year bond issued in July. It addressed investor demand at the shorter end of the yield curve attracting over €9 billion in orders.

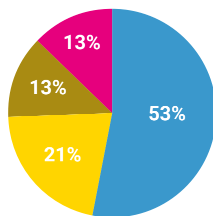
At the Global Capital Bond Awards in May 2018, Siegfried Ruhl, the head of ESM Funding and Investor Relations, won two awards: Overall Most Impressive SSA Funding Official and Most Impressive Supranational Funding Official.

Investor relations

The investor relations team visited the rescue funds' most important investors in 35 countries and 47 cities.



Source: ESM



In 2018, the investor relations team went on 18 roadshows, and conducted 133 investor meetings, updating the rescue fund's most important investors in 35 countries and 47 cities on ESM activities and the funding programme. The ESM also organised four investor forums. The Chairperson of the ESM Board of Governors attended two of these events, showing his strong support for ESM marketing activities. During the year, 60 investors bought ESM or EFSF bonds in the primary market for the first time.

North America

Canada
Montreal
Ottawa
Toronto
Mexico
Mexico City
United States of America
New York
Washington DC

Europe

Austria
Vienna
Azerbaijan
Baku
Bulgaria
Sofia
Croatia
Zagreb
Czech Republic
Prague
Denmark
Copenhagen
Finland
Helsinki
France
Lyon
Paris
Germany
Cologne
Düsseldorf
Hamburg
Hannover
Mainz
Munich
Hungary
Budapest
Italy
Milan
Luxembourg
Luxembourg
Norway
Oslo
Spain
Madrid
Sweden
Stockholm
Switzerland
Basel
Geneva
Zurich
United Kingdom
London

Africa

Algeria
Algiers
Botswana
Gaborone
Morocco
Rabat
Namibia
Windhoek
South Africa
Pretoria
Tunisia
Tunis

Asia

China, People's Republic of
Beijing
India
Mumbai
Indonesia
Bali
Jakarta
Japan
Tokyo
Kazakhstan
Almaty
Korea, Republic of
Seoul
Singapore
Singapore
Sri Lanka
Colombo
Taiwan, Province of China
Taipei

Major rating agencies affirm ESM's high rating position

Table 3
ESM ratings

Fitch			Moody's			DBRS		
Long-term rating	Short-term rating	Rating outlook	Long-term rating	Short-term rating	Rating outlook	Long-term rating	Short-term rating	Rating trend
AAA	F1+	Stable	Aa1	P-1	Positive	AAA	R-1 (high)	Stable

Note: DBRS ratings are unsolicited. DBRS has rated the ESM at AAA since it initiated the rating in April 2014. Fitch has rated the ESM at AAA since inception in October 2012, and Moody's at Aa1 since November 2012. In May 2018, Moody's changed the ESM rating outlook to positive from stable.

Sources: The rating agencies named, compiled by the ESM

"Increasing the international role of the euro is a matter of sovereignty and a decisive step for better protecting European citizens and businesses. This is why we need to strengthen our common currency by completing the architecture of Economic and Monetary Union and creating a eurozone budget."

BRUNO LE MAIRE
Minister for the Economy and Finance, France, ESM Governor

Investment and Treasury

- ESM investment outperforms its long-term benchmarks since inception
- ESM is reimbursed for negative interest costs on cash
- ESM enters into securities lending transactions
- ESM further integrates principles for socially responsible investing

The Investment and Treasury team is entrusted with investing the ESM's paid-in capital, which stood at €80.5 billion at the end of 2018. The paid-in capital will total €80.8 billion in 2027, when the last instalments from all ESM Members are received unless new members join the euro area.

In 2018, the ESM's paid-in capital recorded a return of -0.18%. The negative performance is primarily attributable to the negative yield on the assets in which the ESM invests, in particular the negative remuneration on cash balances left with Eurosystem central banks. However, the fall in German government bond yields, by 11-to-18 basis points in the 5- to 10-year sector, contributed to increase returns, as this pushed the price of fixed-income assets higher.

To reduce the impact of negative yields on its investments, the ESM adjusts the structure of its portfolios to optimise its return within the ESM's risk framework. The ESM kept its cash allocation around an average balance of €58 billion throughout the year. By keeping part of the capital in cash, instead of investing it in short maturity securities, the ESM can reduce the negative yield contribution. German 2-year bonds, for example, were trading between -0.50% and -0.65% in 2018, below the Eurosystem deposit facility rate (-0.40%).

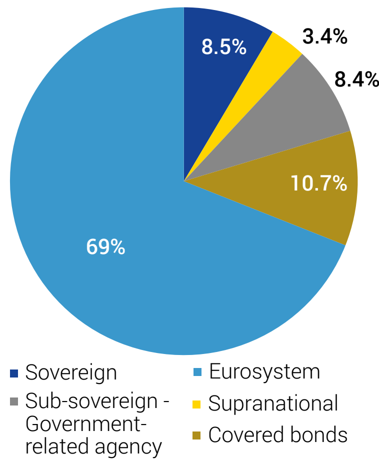
The ESM did not significantly modify its interest rate exposure over the year, to limit the risk of asset depreciation, in anticipation of a potential normalisation of monetary policy. The ESM also continued to increase its investments in covered bonds and in non-euro denominated assets, hedged into euros, which both offer higher returns than highly rated government bonds (Figure 26).

The credit quality of the paid-in capital investments remains at a very high level, in line with the ESM's investment guidelines, which are designed to prioritise capital preservation. The percentage of capital held in cash at Eurosystem central banks or invested in assets rated AA- or higher stood at 95%, almost unchanged from 2017 (Figure 27). The universe of eligible issuers remained broadly stable, adding a small number of covered bond issuers.

The negative performance of the investment portfolios led the ESM to record a negative realised return of €145 million for the year. However, this loss was more than offset by the reimbursement of €216 million of negative interest paid by the ESM on its cash deposits at Eurosystem central banks in 2017. To ensure that the negative interest environment would not erode ESM's long-term creditworthiness, which relies on its paid-in and callable capital, France and Germany had agreed, as a temporary solution, to return the negative interest paid by the ESM on its capital deposited at their respective national central banks. As a result, the accumulated return of the ESM's capital, since 2012, is €1.074 billion, without taking into account the interest reimbursement. The ESM is currently reviewing its investment guidelines to increase the ability to invest over a longer horizon, which should, over time, increase returns while maintaining the ESM's highest creditworthiness.

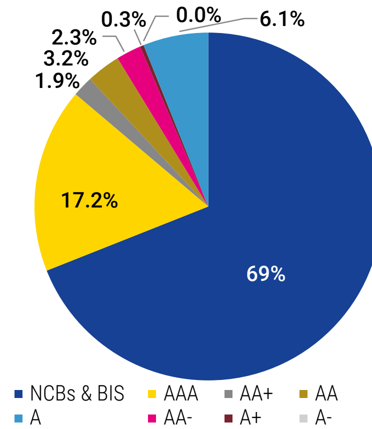
Since 2012 the ESM has outperformed its benchmarks by 0.15% per year — without taking into account the repayment of the negative interest rate charges. The benchmarks consist of indices of AAA/AA rated euro area government and supranational bonds, reflecting the eligible asset classes of the ESM's investment guidelines. The duration of the benchmark is closely aligned with the 0- to 1-year maturity bond index for the short-term tranche, and the 1- to 3-year maturity bond index for the medium/long-term tranche, in line with the ESM's risk appetite. In 2018, the annual performance of the paid-in capital was in line with the benchmark.

Figure 26
Asset class distribution of investments



Source: ESM

Figure 27
Ratings distribution of investments



Source: ESM

ESM progressively increases its use of derivative instruments

The ESM, which deploys derivatives to manage or hedge risks, has expanded its use of these instruments and increased the range of counterparties with whom it can enter into derivatives contracts. This provided the ESM with broader access to the market, which is critical to ensure that the ESM benefits from competitive pricing. The ESM can now enter into derivatives transactions with a dozen commercial banks, with the credit exposure that may arise from these operations fully collateralised. The ESM aims to expand the group of counterparties with additional institutions that meet the eligibility requirements, to ensure best execution and increase diversification of credit exposure.

This expanded capacity was mainly used to increase the ESM's investments in non-euro denominated securities, which reached a €7.2 billion equivalent at the end of 2018 from €5.3 billion a year earlier. Cross-currency swaps enable the ESM to invest in longer-dated non-euro denominated assets without the associated currency risk, thus improving the ESM's ability to diversify its exposure to a broad range of high-quality issuers across geographic regions. As of the end of 2018, the ESM holds assets denominated in six currencies (US dollar, British pound, Japanese yen, Swiss franc, Canadian dollar, and Swedish krona) out of a total of nine that are eligible. The ESM also increased the average maturity of its non-euro investments to 3.9 years from 3.3 years at the end of 2017, benefiting from the higher yield differentials in longer maturities. A large share of the investments, €4.9 billion, is denominated in Japanese yen, offering an additional 50-to-60 basis point spread over the German yield curve.

As interest rates fell, the ESM also increased the use of swaps to manage the interest rate risk of the paid-in capital in a cost efficient manner. By the end of 2018, the total notional amount of interest rate swaps outstanding in connection with the investment of the paid-in capital stood at €2.1 billion.

The ESM launches securities lending using repo and reverse repo operations

In 2018, the ESM initiated its first repo and reverse repo transactions, to benefit from the yield differential between securities that are highly sought after, and those that are not. These transactions involve lending out securities in the portfolio for a short period of time against another, less-scarce security with similar credit quality as collateral. The operations are matched in amount and in maturity, and executed with Eurex as a central clearing counterparty, to ensure a high level of security. While the return varies according to market conditions, in 2018 this activity earned the ESM an additional 10 to 50 basis points on securities lent out for periods between one and four weeks. The volume of repo activity remains limited at this stage, as the stock of securities the ESM owns with significantly higher value in the repo market is currently relatively low. As a secondary benefit, repo transactions also help the ESM to raise liquidity quickly and in a cost-effective manner, should the need arise in periods of market stress.

ESM as a sustainable and responsible investor

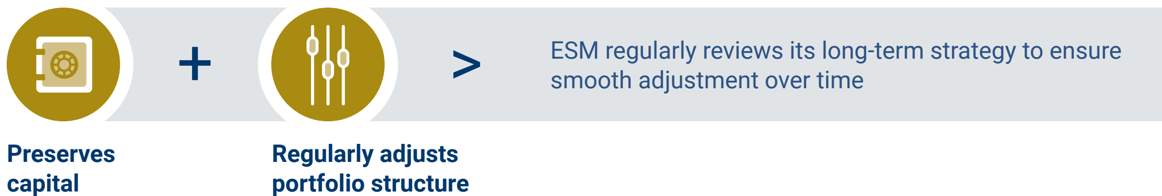
The ESM invests in securities and issuers that are aligned with Environmental, Social, and Governance principles. Entities, such as governments, public agencies, and supranationals with a significant social and environmental contribution accounted for 69% of ESM invested capital, as of the end of 2018.

Out of these investments, €475 million have a targeted purpose such as the financing of social housing or environmental projects. The ESM aims to further integrate responsible investment principles into the management of its assets in the future, while ensuring that these investments remain in line with the ESM's objective to guarantee the ESM's creditworthiness and liquidity.

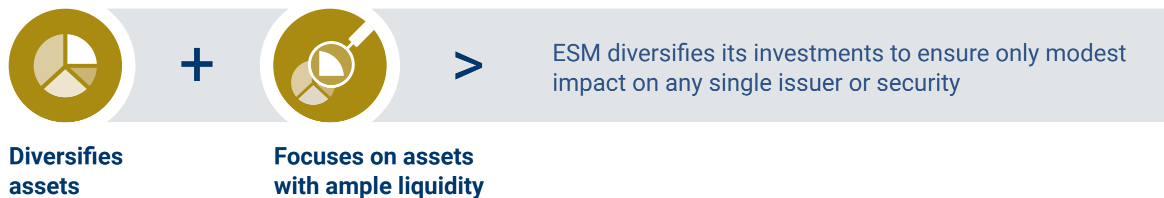
For more on this topic, see 'ESM: committed to public service, transparency, and accountability'.

INVESTMENT STRATEGY PROCESS

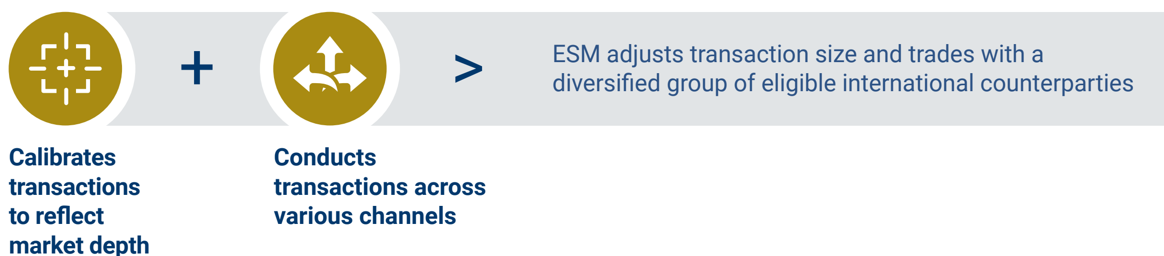
INVESTMENT STRATEGY



ASSET ALLOCATION



MARKET IMPLEMENTATION



Risk and Compliance

- Risk and Compliance maintained effective control of market, credit, liquidity (for both market and funding), operational, reputational, and legal risk.
- Risk and Compliance dynamically adapted the risk and compliance framework to developing business needs within the accepted level of risk appetite.
- Risk and Compliance in 2018 assessed interest rate and foreign currency risks arising from foreign currency investments and US dollar issuances, completed the short-term debt relief measures for Greece, and reinforced the ESM information security framework.
- Risk and Compliance participated in relevant forums to share knowledge and best practice, and also organised and hosted the 12th annual EU Operational Risk Management Forum.

During the year, Risk and Compliance enhanced its methodologies to monitor and manage the risks of debt instruments, capital investments, and their related derivative transactions. Its activity focused on interest rate and foreign exchange risk from investments in foreign currencies and USD issuances. It also worked on reducing the interest rate risk on the Greek loans, fulfilling one of the objectives of the short-term debt measures for Greece. For more information on these and related measures, see 'Greek programme achievements'.

The Risk and Compliance team updated the ESM's risk policies in response to recent initiatives and the introduction of new tools. It established a new policy for financial model validation and model risk management and updated the ESM's funding liquidity risk policy and credit risk policy. It also finalised the annual review of the ESM's High Level Principles for Risk Management and ESM Risk Policy.

In line with previous recommendations from the Basel Committee on Banking Supervision, Risk and Compliance uses in-house models to monitor both credit risk exposure from its investment activities and counterparty risk from its derivative and collateral management operations. In addition, Risk and Compliance conducts an annual review and regular reporting to the Internal Risk Committee and the Board Risk Committee.

The ESM Risk function expanded its monitoring capacity of emerging risks arising from financial market trends and emerging geopolitical risks to assess both their potential impact on the ESM and if ESM risk appetite requires refining. The analysis looks at how discrete risks (credit, liquidity, market, and operational) should be managed to ensure the ESM's preparedness.

Integrity, confidentiality, and accessibility of information are critical for the ESM. Risk, together with the information technology (IT) team, use best practices in independent risk assessments and evaluations of controls to ensure the appropriate mitigation of cybersecurity risks.

"Twenty years from its inception, the euro has established itself as the most important international currency next to the dollar. Progress towards the completion of monetary union together with coordinated action by the euro area members is necessary to further strengthen the international role of the euro."

GIOVANNI TRIA

Minister of Economy and Finance, Italy, ESM Governor

"Undoubtedly, the euro has become a symbol of Europe in the world, in its 20 years of existence. It is my firm belief that its international role could and should be further strengthened as a safe and reliable currency. This will also enhance the euro area's political, economic, and financial weight."

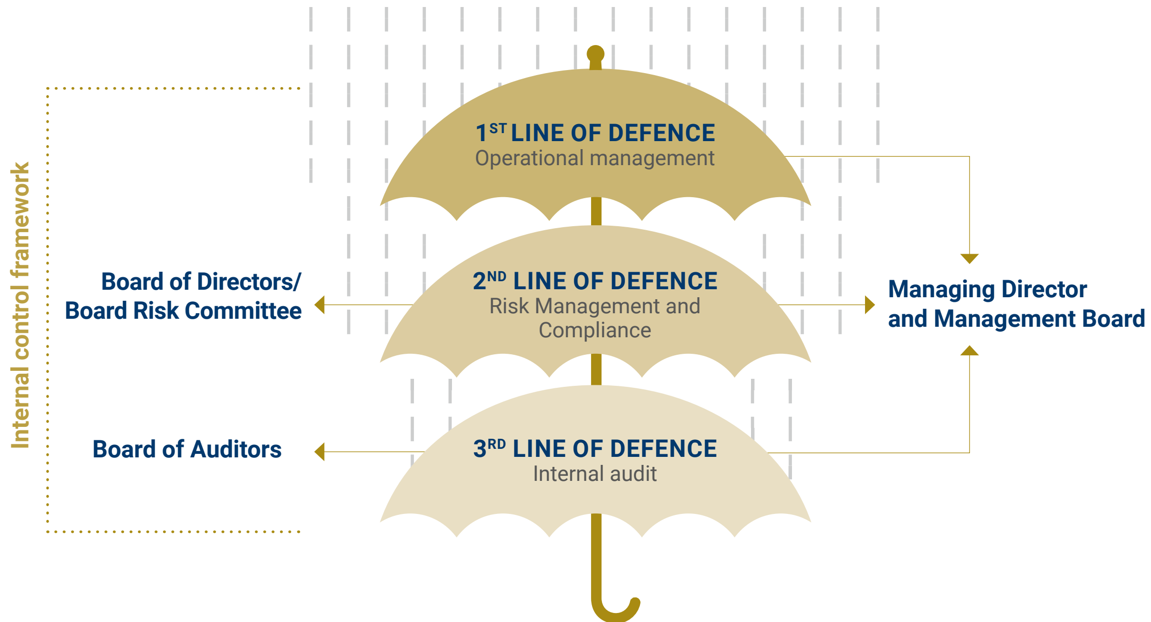
HARRIS GEORGIADES
Minister of Finance, Cyprus,
ESM Governor

The ESM must be vigilant in protecting its critical assets against inevitable cyber security risks. To safeguard the ESM, various methods, including multiple layers of defence as well as detective and protective controls, are applied. The ESM continuously trains staff on information security and cyber risks associated with new technologies. The ESM tries to identify all possible cyber risks to, and potential impacts on, its most critical assets, deciding on the best approach for each case.

Monitoring is a core objective of the Risk and Compliance function and each activity is assessed in relation to potential financial and non-financial risks, with the use of key risk indicators and regular reporting to both the Internal Risk Committee and the Board Risk Committee.

Risk and Compliance at the ESM is built on a best practice framework, consistent with the ESM Treaty and the High Level Principles for Risk Management. For detailed information, see our website.

THE THREE LINES OF DEFENCE MODEL



The ESM follows the 'three lines of defence' governance model, which sets out clearly drawn lines of authority and appropriate segregation of powers and duties for risk management.

The **first line of defence** consists of business functions and departments with direct responsibility for the day-to-day management of risk. **The second line of defence** is performed by an independent risk management and compliance function, led by the Chief Risk Officer, which oversees the risks assumed by the business and ensures they are appropriately managed and monitored. **The third line of defence** consists of an independent internal audit function, led by the Head of Internal Audit, responsible for providing the Board of Directors with assurance that risk management controls are operating properly and efficiently. Both the Chief Risk Officer and Internal Auditor report directly to the Managing Director, as well as to, respectively, the Board Risk Committee and the Board of Auditors, to ensure their independence.

Compliance – part of the second line of defence

The Compliance function supports the business, in line with the ESM Compliance Charter, by addressing risks in connection with personal ethical conduct, such as potential conflicts of interest over private investments, anti-money laundering, corruption prevention, privacy requirements and the ESM's market conduct, including the maintenance of information barriers.

The ESM regularly reviews and amends the compliance policies to reflect changes in business processes, external requirements, industry best practice, or regulatory guidance where applicable.

The compliance officer monitors activity and adherence to the Code of Conduct and other policies such as those on information barriers and data protection, sending reviews on a quarterly basis to the Internal Risk Committee and the Board Risk Committee for discussion and follow-up action.

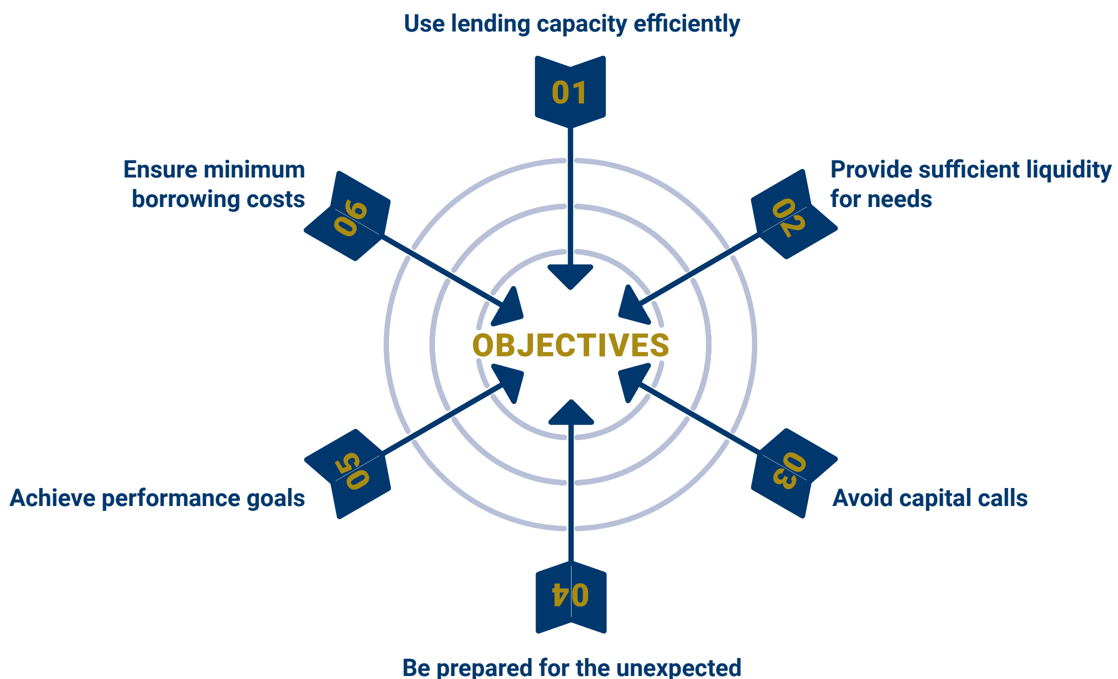
From 25 May 2018, the General Data Protection Regulation (GDPR) replaced the EU Directive 95/46/EC on data protection. Although the ESM is not directly subject to the GDPR, it is in the process of updating its personal data protection policy and is cooperating with other international organisations to share experiences and best practices. The amended policy will provide for more detailed rules on ESM personal data processing and privacy. Staff training sessions will follow the approval of the updated policy.

Risk awareness and networking

The ESM holds regular workshops and seminars on specialised risk topics to improve performance and keep staff abreast of developments and best practices. In 2018, Risk and Compliance focused on training staff on operational risk management, fraud prevention, and compliance matters.

As part of the ESM's continued participation in a network of international financial institutions (IFIs), the Risk and Compliance team hosted the 12th annual EU Operational Risk Management Forum, bringing together over 10 different IFIs in November 2018. Institutions exchanged views and best practices on model validation, cyber security risks, and change management. In April, the team participated in the Annual Central Bank Forum of risk managers in Mexico, during which it presented the ESM's operational risk framework to participating central banks and IFIs.

ESM RISK MANAGEMENT OBJECTIVES



FOUR-STEP MANAGEMENT PROCESS

01 RISK IDENTIFICATION

Identification of all material risk exposures, both financial (credit, market, and liquidity risk) and non-financial (operational, reputational, legal, compliance, and political).

02 RISK ASSESSMENT AND MEASUREMENT

Assessment of identified risk exposures to determine their materiality, based on a combination of quantitative tools and expert judgement.

03 RISK MONITORING AND CONTROL

On-going monitoring and control of material risk exposures, including limit frameworks, key risk indicators, reporting, and escalation.

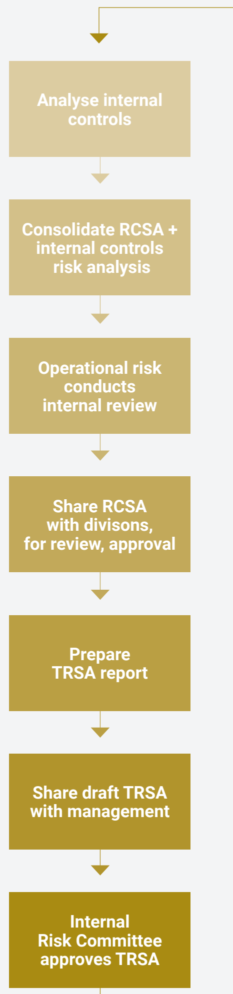
04 RISK MANAGEMENT

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

"The international role of the euro is primarily based on market-driven factors and reflects the credibility of the euro area. It is in our interest to strengthen the economic resilience of Economic and Monetary Union against economic shocks, to develop capital markets, and to reduce vulnerability to external factors."

JĀNIS REIRS
Minister of Finance, Latvia,
ESM Governor

Focus on the Risk and Control Self-Assessment (RCSA) process



The Risk and Control Self-Assessment (RCSA) is designed to identify and evaluate risks and associated controls. Its regular practice aids in integrating risk management practices and culture into staff's daily activities. The RCSA, introduced in 2015, is therefore an integral part of the overall operational risk framework at the ESM.

In 2018, the ESM reinforced its RCSA practice by reviewing the link between its Operational Risk framework and international standards set by the Basel committee. As a result, the ESM now incorporates the second level of Basel operational risk categories, which has improved the ESM's ability to monitor, control, and assess the risk of pricing errors, settlement failures, or unauthorised access to systems. This work forms the basis for an enterprise-level assessment of the ESM's risk exposure. Risk also mapped the library of ESM controls – the Internal Control Framework and related process flows – to the RCSA providing a more granular view of the potential risks for each division. The outcome of each division's RCSA is the basis for the Top Risk Self-Assessment (TRSA) report, in which the Risk team provides the Management Board and the Board Risk Committee an enterprise view of major risks (e.g. cybersecurity, capital preservation).

The RCSA includes post-action mitigation plans, providing a forecast of the exposure and a base of comparison for follow-up and monitoring. This activity enabled the creation of a risk library that standardises the management of operational risk elements, such as RCSA risks, controls, key risk indicators, incidents as well as action plans.

ESM: committed to public service, transparency, and accountability

As an intergovernmental institution with a public mandate, the ESM is committed to the highest standards of public service. ESM staff are dedicated to fulfilling their work in this spirit. This translates into internal practices, policies, and values in use when ESM staff carry out the institution's mission. This is also reflected in the ESM's commitment to Environmental, Social, and Governance practices, as well as ongoing efforts to enhance the institution's accountability and transparency.

Environment, social, governance practices

Environment: The ESM is committed to protecting the environment and thus follows a prudent approach to environmental matters. The ESM Code of Conduct calls for ESM staff to operate in a way that limits the carbon footprint and maximises the re-use of material.

As such, the ESM continuously implements measures to improve its internal environmental impact and reduce the use of natural resources and energy as well as the generation of emissions and waste. Once again in 2018, the ESM obtained a certificate from the Luxembourg government on the sound treatment of energy sources and the recycling of waste. The ESM also encourages its staff to use public transport or other energy efficient modes of transport and be environmentally conscious.

Social: With its internal policies and procedures, the ESM endeavours to ensure that its activities are conducted in line with the highest standards of integrity. The ESM considers its members of staff to be its most valuable asset and actively supports their wellbeing by promoting a healthy work-life balance through flexible working arrangements. The ESM fosters diverse ideas and a diverse working environment by providing equal opportunity to all its staff.

The ESM also adheres to environmental and social principles when investing its €80.5 billion in paid-in capital. For more information on the ESM as a sustainable and responsible, see the Investment and Treasury section.

Governance: The ESM has a robust governance framework in place, which ensures strong accountability and transparency vis-à-vis both the ESM shareholders and other stakeholders.

Transparency and accountability

Accountability and transparency are embedded in the ESM's governance as its Board of Governors comprises finance ministers representing the democratically elected governments of the ESM Members. National parliamentary procedures, sometimes required by ESM Members before approving ESM decisions, make the ESM also indirectly accountable to parliaments.

"The euro is a relatively young currency; nevertheless it is the second most important currency in the world. This shows its potential. More confidence in the euro area economy would lead to a stronger international role of the euro. The Economic and Monetary Union deepening initiatives, especially the completion of the banking union and capital markets union as well as strengthening the role of the ESM in the Economic and Monetary Union architecture, which, we are intensively working on, would also contribute to this objective."

VILIUS ŠAPOKA
Minister of Finance, Lithuania,
ESM Governor

The independent Board of Auditors has a full public audit mandate and provides extensive audit oversight. The Board of Auditors' annual report to the Board of Governors, together with the ESM management comments in response to the report, are made available to the national parliaments and supreme audit institutions of the ESM Members, the European Parliament, and the European Court of Auditors. The report, together with ESM management comments, is available to the public on the ESM website.

To enhance the transparency and evaluability of its financial assistance programmes, in 2018 the ESM set up a programme database, which provides data on programme disbursements, lending, conditionality, and forecasting. The new database, which will go live to the public in 2019, is in response to the June 2017 Board of Governors mandate to address some of the recommendations from the first evaluation of EFSF and ESM financial assistance, which was led by the High-Level Independent Evaluator Gertrude Tumpel-Gugerell.

To enhance familiarity with the ESM's work across the EU and elsewhere in the world, the ESM's Managing Director, and other management board and staff members spoke at various conferences, seminars, and academic gatherings in 2018. ESM researchers explore mandate-related topics in publically available series, working papers, and discussion papers. The ESM welcomed 15 international visitor and student groups and continued its ongoing dialogue with the media.

The ESM Managing Director also regularly attended the European Parliament's Economic and Monetary Affairs Committee and made appearances at national parliaments.

Evaluation of financial assistance programmes

In the second half of 2018, the ESM started preparatory work for a second evaluation in response to the June 2017 Board of Governors' commitment to "an evaluation of the Greek programmes after completion" and the end of the ESM programme for Greece on 20 August 2018. On 18 February 2019, the Chairperson of the Board of Governors appointed Joaquín Almunia, former European Commission Vice-President, as the High-Level Independent Evaluator. The evaluation's objective will be to enhance the relevance and effectiveness of ESM's programme-related activities, and support informed future policy decision-making. The conclusions and recommendations of this second evaluation will be presented to the ESM Board of Governors at its Annual Meeting in June 2020.

"Thanks to the unprecedented reform efforts we have collectively embarked upon following the crisis, the euro is today firmly set on a solid footing. Its role on the international stage will unquestionably strengthen from here on, as confidence in our common currency further gains ground."

PIERRE GRAMEGNA
Minister of Finance, Luxembourg,
ESM Governor

03 Institutional framework and organisation

The ESM financial assistance toolkit

The ESM has a number of financial assistance instruments at its disposal to fulfil its mission, though it has used only two to-date. The ESM deploys these funds in exchange for reforms to address the causes that led to requests for ESM financial stability support.

ESM loans

Goal: to assist ESM Members in significant need of financing, and which have lost access to capital markets, either because they cannot find lenders or because the financing costs are so high it would undermine the sustainability of public finances.

Conditional upon: the implementation of macroeconomic reform programmes, negotiated by the European Commission in liaison with the ECB and, where possible, the IMF.

Used: in Ireland and Portugal (EFSF), in Greece (EFSF and ESM), and in Cyprus (ESM).

Loans for indirect bank recapitalisation

Goal: to assist an ESM Member by addressing those cases where the financial sector is primarily at the root of a crisis.

Conditional upon: reforms to financial supervision, corporate governance of banks, and applicable law and regulations on bank recapitalisation, restructuring, and resolution.

Used: in Spain (ESM).

Precautionary credit line

Goal: to prevent crises from emerging or developing, by helping countries whose economic conditions are still sound to maintain market access by strengthening the credibility of their macroeconomic performance.

The December 2018 Euro Summit decided to enhance the effectiveness of precautionary instruments. For more information on the summit decisions, see 'December 2018 Euro Summit marks new chapter for the ESM'.

There are two types of credit lines:

A precautionary conditioned credit line is available to an ESM Member whose economic and financial situation is fundamentally sound and meets the eligibility criteria.

An enhanced conditions credit line is available to an ESM Member that does not comply with some of the eligibility criteria required for accessing a precautionary conditioned credit line but whose economic and financial situation remains sound.

Used: no.

Primary market purchases

Goal: to support an ESM Member's bond auction, the ESM may buy debt securities at market prices in the primary market, in other words directly from the issuing ESM Members.

Conditional upon: no conditionality beyond the underlying programme, as this tool complements a regular loan instrument or a precautionary programme.

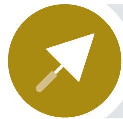
Used: no.

Secondary market purchases

Goal: to support the sound functioning of the government debt market when a lack of liquidity threatens the financial stability of an ESM Member whose economic and financial situation is otherwise fundamentally sound. This instrument can be used within or outside a macroeconomic adjustment programme.

Conditional upon: specific policy conditions apply for countries not under a programme.

Used: no.



Direct Recapitalisation Instrument (DRI)

Goal: to help remove a serious risk of contagion from the financial sector to the sovereign. The total amount available for this instrument is limited to €60 billion and can only be used for systemically important financial institutions, as defined in the relevant EU legislation.

Conditional upon: measures to address the sources of difficulties in the financial sector and the general economic situation of the country. Eligible financial institutions are those that, for example, are unable to attract sufficient capital from the private sector and for which existing burden-sharing arrangements on bank recapitalisation, restructuring, and resolution, in particular the bail-in requirements according to Article 27 of the Single Resolution Mechanism regulation, are insufficient.

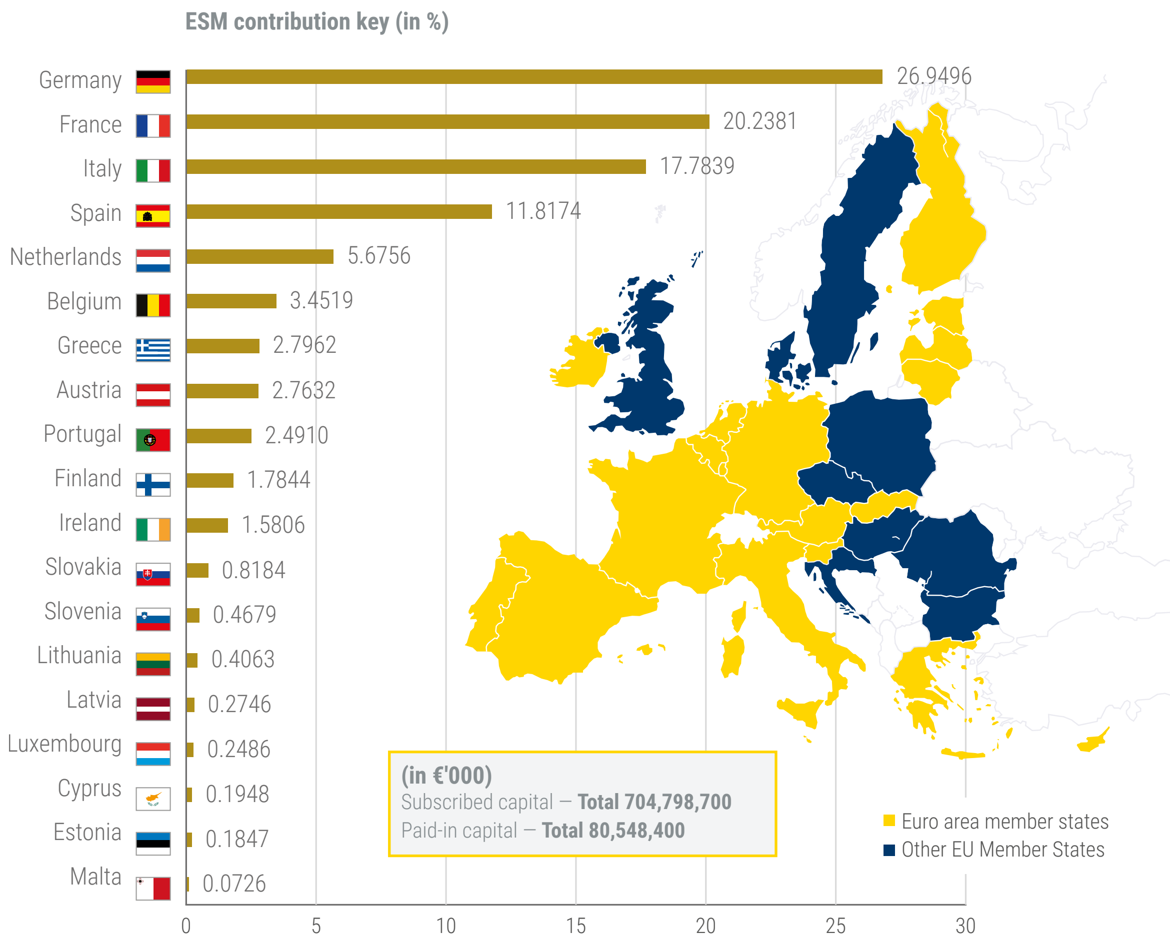
Used: no.

At the December 2018 Euro Summit, leaders also decided that the ESM will provide a credit line to be drawn upon if needed by the SRF, a tool which will become a new instrument in the ESM's toolkit. When the ESM assumes the common backstop provider role, the DRI will be cancelled. For more information on this new mandate, see 'December 2018 Euro Summit marks new chapter for the ESM'.

Governance

ESM shareholders

The ESM shareholders are the 19 euro area member states that are also referred to as ESM Members. Each Member has contributed to the ESM's authorised capital based on the ESM Members' respective shares of the EU's total population and GDP. The authorised capital amounts to €704.8 billion and is divided into paid-in and callable capital. The paid-in capital currently stands at €80.55 billion.[20]



Note: As of 30 April 2019.
Source: ESM
*The accession of new ESM Members is factored into the capital key, reducing the existing ESM Members' contribution keys. Individual nominal capital subscriptions and paid-in capital amounts remain unchanged for the existing ESM Members. In line with Article 42 of the ESM Treaty, ESM Members with GDP per capita of less than 75% of the EU average in the year immediately preceding their ESM accession benefit from a temporary correction mechanism. During this period, the initial capital subscription of the ESM Member benefiting from the correction is lower, thus leading temporarily to a lower paid-in capital contribution. Once this period ends, the ESM Member must deposit the remaining amount. Most recently, Slovenia's temporary correction period expired on 1 January 2019, and Slovenia deposited the remaining paid-in capital contribution. Malta, Slovakia, Estonia, Latvia, and Lithuania are currently benefiting from temporary corrections, the last of which terminates at the end of 2026.

[20] As at 30 April 2019.

Governance structure

BOARD OF GOVERNORS

BOARD OF AUDITORS

MANAGING DIRECTOR

BOARD OF DIRECTORS

BOARD RISK COMMITTEE

BUDGET REVIEW AND COMPENSATION COMMITTEE

MANAGEMENT BOARD

FINANCE COMMITTEE

INCIDENT MANAGEMENT TEAM

INVESTMENT MANAGEMENT TEAM

INTERNAL RISK COMMITTEE

BANKING COMMITTEE

CORPORATE PROJECTS COMMITTEE

INTERNAL COMMITTEES

The Board of Governors meets at least once a year and whenever the affairs of the ESM so require. The Board of Directors also meets whenever the affairs of the ESM so require (nine times in 2018), while the Board Risk Committee and the Budget Review and Compensation Committee meet regularly each quarter and additionally when required.

For more information on our governance structure, visit our website.

Board of Governors

Annual Meeting of the Board of Governors

On 21 June 2018, the Board of Governors held its sixth annual meeting at the ESM premises in Luxembourg.

In his presentation to the Board of Governors, the Managing Director highlighted the key achievements of the ESM during the past year, including its funding operations, investment and lending activities, and institutional developments.

In addition, the Chairperson of the Board of Auditors addressed the Governors with regard to the Board of Auditors' annual report to the Board of Governors as well as the Board of Auditors' report in respect of the ESM 2017 financial statements. Furthermore, the external auditor presented its report in respect of the audit of the ESM 2017 financial statements.

On the occasion, the Board of Governors also approved the *ESM 2017 Annual Report* as drawn up by the ESM Managing Director.

"The strengthening of the international role of the euro brings benefits for citizens and businesses alike, whilst contributing to the resilience of the international financial system especially against exchange rate shocks."

EDWARD SCICLUNA

Minister of Finance, Malta,
ESM Governor

Members of the Board of Governors

Portugal

Mário Centeno
Chairperson of the Board of Governors since 13 January 2018,
Minister of Finance,
Governor since 26 November 2015

Greece

Euclid Tsakalotos
Minister of Finance,
Governor since 6 July 2015

Belgium

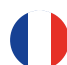
Alexander De Croo
Deputy Prime Minister, Minister of Finance and Development Cooperation,
Governor since 11 December 2018
replacing Johan Van Overtveldt,
Governor since 15 December 2014

Spain

Nadia Calviño
Minister for Economy and Business,
Governor since 7 June 2018
replacing Román Escolano,
Governor since 7 March 2018
replacing Luis de Guindos,
Governor since 27 September 2012

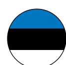
Germany

Olaf Scholz
Federal Minister of Finance,
Governor since 14 March 2018
replacing Peter Altmaier,
Governor since 24 October 2017



France

Bruno Le Maire
Minister of Economy and Finance,
Governor since 25 May 2017



Estonia

Martin Helme
Minister of Finance,
Governor since 29 April 2019
replacing Toomas Tõniste,
Governor since 12 June 2017

Italy

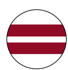
Giovanni Tria
Minister of Economy and Finance,
Governor since 1 June 2018
replacing Pier Carlo Padoan,
Governor since 24 February 2014

Ireland

Paschal Donohoe
Minister of Finance and Public Expenditure and Reform,
Governor since 15 June 2017

Cyprus

Harris Georgiades
Minister of Finance,
Governor since 3 April 2013



Latvia

Jānis Reirs
Minister of Finance,
Governor since 19 February 2019
replacing Dana Reizniece-Ozola,
Governor since 22 March 2016

Austria

Hartwig Löger
Federal Minister of Finance,
Governor since 26 January 2018
replacing Hans-Jörg Schelling, Governor
since 1 September 2014

Lithuania

Vilius Šapoka
Minister of Finance,
Governor since 13 December 2016

Slovenia

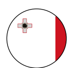
Andrej Bertoncelj
Minister of Finance,
Governor since 13 September 2018
replacing Mateja Vraničar Erman,
Governor since 21 September 2016

Luxembourg

Pierre Gramegna
Minister of Finance,
Governor since 4 December 2013

Slovakia

Ladislav Kamenický
Minister of Finance, Governor since
7 May 2019
replacing Peter Kažimír, Governor since
27 September 2012



Malta

Edward Scicluna
Minister of Finance,
Governor since 13 March 2013

Finland

Petteri Orpo
Minister of Finance,
Governor since 29 June 2016

Netherlands

Wopke Hoekstra
Minister of Finance,
Governor since 26 October 2017

Shareholder engagement

The ESM strives to maintain strong and effective shareholder relations. Effective shareholder engagement is key to the ESM fulfilling its mandate while remaining fully accountable to its Members.

In 2018, the ESM organised its fifth annual shareholders day, which once again brought together representatives from all 19 ESM Members, who work in their respective ministries of finance on ESM-related matters, as well as representatives from the European Commission and the Eurogroup Working Group Secretariat. The majority of participants came to the ESM for the first time and the event provided them an opportunity to gain insight into a wide range of ESM activities, from internal corporate operations to responding to market challenges and the setting of priorities.

To discuss relevant matters, the ESM also participated in various forums where its shareholders are represented, such as the Eurogroup, the Eurogroup Working Group, the Task Force on Coordinated Action, and other relevant technical working groups.

"A stronger international role for the euro will underpin Europe's commitment to an open, multilateral, and rules-based global economy. Increased use of the euro across the globe will enable European citizens and businesses to benefit from free and smooth trade and cheap and reliable access to finance."

WOPKE HOEKSTRA

Minister of Finance, The Netherlands, ESM Governor

Board of Directors

Members of the Board of Directors

CHAIR OF THE MEETINGS OF THE BOARD OF DIRECTORS

Klaus Regling
ESM Managing Director

Ireland

Nicholas O'Brien
Assistant Secretary General, Department of Finance, appointed on 3 July 2014
Member of the Budget Review and Compensation Committee since 30 September 2014, reappointed until 8 October 2019

Belgium

Steven Costers
Counselor General, Ministry of Finance, appointed on 1 May 2015

Greece

George Chouliarakis
Alternate Minister of Finance, Ministry of Finance, appointed on 4 February 2015

Germany

Jörg Kukies
State Secretary, Federal Ministry of Finance, appointed on 9 April 2018
replacing Thomas Steffen, originally appointed on 24 September 2012
Member of the Budget Review and Compensation Committee since 14 May 2018, appointed until 8 October 2020

Spain

Carlos San Basilio
Secretary General for Treasury and International Financing, Ministry of Economy and Business, appointed on 19 June 2018
replacing Fernando Navarrete, appointed on 11 April 2018
Member of the Budget Review and Compensation Committee since 13 July 2018, appointed until 8 October 2020

Estonia

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

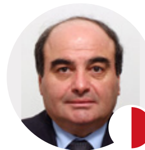
France

Odile Renaud Basso
Director General of the Treasury, Ministry of Finance and Public Accounts, appointed on 30 June 2016
Member of the Board Risk Committee since 10 February 2017, reappointed until 8 October 2020

Italy

Alessandro Rivera

Director General of the Treasury,
Ministry of Economy and Finance,
appointed on 27 July 2018
replacing Gelsomina Vigliotti, appointed on 15 May 2018,
replacing Vincenzo La Via, originally appointed on 8 October 2012
Member of the Board Risk Committee since 20 September 2018,
appointed until 8 October 2021



Malta

Alfred Camilleri

Permanent Secretary, Ministry of Finance,
appointed on 8 October 2012
Member of the Budget Review and Compensation Committee since 9 October 2012,
reappointed until 8 October 2019
Chairperson of the Budget Review and Compensation Committee since 24 April 2014,
reappointed until 8 October 2019

Cyprus

George Panteli

Director of the Economic Research and European Union Affairs Directorate,
Ministry of Finance,
appointed on 29 April 2013

Netherlands

Christiaan Rebergen

Treasurer-General, Ministry of Finance,
appointed on 6 June 2018
replacing Michel Heijdra,
appointed on 1 February 2018
replacing Hans Vijlbrief, originally appointed on 27 September 2012

Latvia

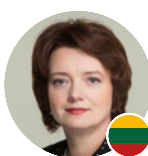
Līga Kļaviņa

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

Austria

Harald Waiglein

Director General for Economic Policy,
Financial Markets and Customs Duties,
Federal Ministry of Finance,
appointed on 8 October 2012
Member of the Board Risk Committee since 9 October 2012, reappointed until 8 October 2019
Chairperson of the Board Risk Committee since 8 June 2018



Lithuania

Miglė Tuskienė

Vice-Minister, Ministry of Finance,
appointed on 4 March 2015

Portugal

Ricardo Mourinho Félix

Deputy Finance Minister and Secretary of State for Finance, Ministry of Finance,
appointed on 7 December 2015
Member of the Board Risk Committee since 7 April 2016, reappointed until 8 October 2019

Luxembourg

Isabelle Goubin

Director of the Treasury,
Ministry of Finance,
appointed on 19 March 2014
Member of the Budget Review and Compensation Committee since 24 April 2014, reappointed until 8 October 2021

Slovenia

Katja Lautar

Head of Department for General Government Analysis and Coordination of Economic Policies, Ministry of Finance,
appointed on 19 February 2019
replacing Gorazd Renčelj,
originally appointed on 10 February 2017

Slovakia

Peter Paluš

Head of Financial Unit at Permanent Representation of Slovakia to the European Union, appointed on 22 February 2017
Member of the Board Risk Committee since 8 February 2018,
appointed until 8 October 2020

Finland

Tuomas Saarenheimo

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

"The euro has become the second most important reserve currency in the world. We should promote its status as a strong currency since this will contribute to the economic well-being of the euro area countries. The ESM has a role to play in this respect by guaranteeing financial stability."

HARTWIG LÖGER
Federal Minister of Finance, Austria,
ESM Governor

Board of Auditors

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

The Board of Auditors is composed of five members appointed by the Board of Governors in line with Article 24 of the By-Laws. New members of the Board of Auditors are appointed for a non-renewable term of three years. In October 2018, the Board of Governors appointed Irena Petruškevičienė and Noel Camilleri to the Board of Auditors, replacing Jean Guill and Andrew Harkness whose terms had come to an end. Furthermore, the Board of Governors appointed Tommaso Fabi in April 2019 to replace Günter Borgel, whose term had also come to an end.

In 2018, the Board of Auditors held 10 meetings at the ESM premises. During these meetings, ESM management and senior staff updated the Board of Auditors on recent ESM activities, the decisions of the ESM governing bodies, and other relevant issues and developments. The Board of Auditors met regularly with the internal audit function, and monitored and reviewed the work and independence of the external auditors. In addition, the Chairperson and Vice Chairperson of the Board of Auditors met once with the ESM Board of Directors. Furthermore, the Chairperson of the Board of Auditors met with the Chairperson of the Board of Governors and attended the Annual Meeting of the Board of Governors to discuss the work and conclusions of the Board of Auditors.

During the year, the Board of Auditors also carried out an independent audit of ESM consultancy expenses with the support of subject matter experts from the French Court of Auditors and of the internal control framework with the support of subject matter experts from the European Court of Auditors. In fulfilling its role, the Board of Auditors also reviewed the ESM 2018 Financial Statements and the working papers of the external auditor.

In addition to its annual report in respect of the ESM financial statements included in the ESM annual report, the Board of Auditors also draws up an annual report to the Board of Governors which summarises its audit work and its recommendations for the respective year.

The Board of Auditors' annual report, together with the ESM management comments in response to the report, are made available to the national parliaments, the supreme audit institutions of the ESM Members, the European Parliament, and the European Court of Auditors. The public can access these documents on the ESM website.

"The euro plays an important cohesive role in Europe. Its internationalisation will further enhance its contribution to stability and growth."

ANDREJ BERTONCELJ

Minister of Finance, Slovenia,
ESM Governor

Members of the Board of Auditors

Kevin Cardiff
Chairperson since 21 February 2017
Member since 17 December 2016
Appointed upon nomination by the European Court of Auditors.

François-Roger Cazala
Vice Chairperson since 21 February 2017
Member since 8 October 2016
Appointed upon nomination by the French Supreme Audit Institution.

Noel Camilleri
Member since 8 October 2018
Appointed upon nomination by the Supreme Audit Institution of Malta.

Irena Petruškevičienė
Member since 8 October 2018
Appointed upon proposal of the Chairperson of the Board of Governors.

Tommaso Fabi
Member since 1 April 2019
Appointed upon proposal of the Chairperson of the Board of Governors.

Note: In line with Article 24 of the By-Laws, two members are appointed upon proposal of the Chairperson of the Board of Governors, two members upon nomination by the supreme audit institutions of the ESM Members based on a system of rotation, and one member by the European Court of Auditors.

Internal control framework

The ESM internal control framework is embedded in ESMv daily operations and reflects the nature, complexity, and risks inherent in ESM activities. The ESM internal controls are underpinned by the three lines of defence governance model established by the Board of Directors and are aligned with the principles of the Basel Committee's Framework for Internal Control Systems in Banking Organisations.[21]

[21] Framework for Internal Control Systems in Banking Organisations, Basel Committee on Banking Supervision, Basel, September 1998.

ENTITY-LEVEL CONTROLS

Include management oversight and control culture, risk recognition and assessment, reliable information systems, availability of information relevant to decision making, and processes for monitoring and correcting deficiencies.

PROCESS-LEVEL CONTROLS

Include operational controls embedded in key processes and transactions.

INFORMATION TECHNOLOGY (IT) CONTROLS

Include IT general controls over the IT environment, computer operations, access to programs and data, program development, change management and automated transaction processing controls.

"The European Union is a global player. To strengthen our position in the rapidly changing environment, the euro needs to stay sound and well respected. To achieve this we need to complete the architecture of Economic and Monetary Union, push on with structural reforms, and invest into sustainable growth.".

LADISLAV KAMENICKÝ
Minister of Finance, Slovakia,
ESM Governor

"Strengthening the international role of the euro should be considered more of a positive spillover effect of strengthening Economic and Monetary Union than a goal in itself. While there are benefits from increasing trading in euro among euro area actors, companies need to be able to freely choose the currency they do business in."

PETTERI ORPO
Minister of Finance, Finland,
ESM Governor

The Board of Directors, directly and through the Board Risk Committee, is periodically updated on the state of ESM's internal controls.

The Managing Director, under the direction of the Board of Directors, is responsible for the ongoing maintenance of the ESM internal control framework. Assisted by the Management Board, the Managing Director sets a strong tone from the top and oversees internal controls across all areas of the ESM. Each year, the Managing Director issues a management report on the state of internal controls to the Board of Directors (via the Board Risk Committee) and the Board of Auditors.

Internal audit provides an independent assurance on the established internal controls and procedures as part of the regular audit cycle. Internal audit independently reviews the entity-level controls on an annual basis.

The external auditor gains a sufficient understanding of ESM internal controls to provide reasonable assurance of the accuracy of the ESM's financial statements.

There are inherent limitations to the effectiveness of any system of internal controls, including the possibility of human error or circumvention of overriding controls. Therefore, even an effective internal control framework can provide only reasonable assurance.

ESM organisational structure

Managing Director
K. Regling

- **Head of Communications/ Chief Spokesperson** — W. Proissl
- **Head of Internal Audit** — L. Lucas
- **Chief Risk Officer/ Head of Risk and Compliance** — C. Pacciani
- **General Counsel** — D. Eatough
  - **Head of Legal** — J. Aerts
  - **Head of HR and Organisation** — S. De Beule-Roloff

Secretary General — K. Anev Janse
- **Head of Funding and Investor Relations** — S. Ruhl
- **Head of IT and Operations** — D. Wallace
- **Head of ALM and Lending** — P.-H. Floquet
- **Head of Corporate Governance and Internal Policies** — F. Zinoecker

Deputy MD and Chief Finance Officer — C. Frankel
- **Head of Investment and Treasury** — S. Levy
- **Head of Finance and Control** — T. Pies

Chief Economist — R. Strauch
- **Head of Economic and Market Analysis** — J. Rojas
- **Head of Strategy and Institutional Relations** — N. Giammarioli
- **Head of Banking** — N. Mascher

Chief Corporate Officer — F. Blondeel
- **Head of Middle and Back Office and Portfolio Performance** — M. Hickey
- **Commercial Legal and Procurement**
- **Coordination**

Member of the Management Board

Secondary reporting line

Visit our website for more information on our organisational structure and a description of the activities of the various departments.

As part of the ESM's continued maturing process, the ESM, led by its extended leadership team, updated its mission statement in early 2019.

The ESM's mission is to enable the countries of the euro area to avoid and overcome financial crises and to maintain long-term financial stability and prosperity.

04 Financial report

Balance sheet

At year-end, the total ESM balance sheet was €807.1 billion. Compared to 31 December 2017, the balance sheet increased by €10.1 billion, mainly due to new loan disbursements in 2018. The ESM disbursed €21.7 billion in loans to Greece and received early repayments from Spain of €8 billion.

To provide financial assistance to the beneficiary Member States, the ESM relies on its funding activity. In 2018, the total liability in respect of debts evidenced by certificates increased by €9.2 billion to €98.4 billion (€89.2 billion in 2017), reflecting the increase in lending activity.

As of 31 December 2018, the total €80.5 billion of paid-in capital is invested in debt securities or held in cash.

Unrealised gains or losses resulting from the valuation of the security portfolio are reflected in the Fair value reserve within the ESM's equity position. As of 31 December 2018, this reserve was €140.2 million, compared to €99.1 million as of 31 December 2017. The increase in the *Fair value reserve* mainly reflects the appreciation of the investment's values on the market compared to the previous year, largely due to changes in interest rates.

Profit and loss account

The ESM recorded a net income of €284.7 million for the financial year 2018, compared to €68.6 million in 2017.

The €216.1 million increase is mainly due to the amount received from Germany and France, compensating the ESM for a part of the negative interest charged on the cash held at their national central banks in 2017. These payments, which represent €128.9 million and €86.7 million, respectively, were recorded as part of *Extraordinary income* together with €26.8 million that the ESM will receive from the European Commission, following a May 2018 decision by the Council of the European Union to impose a fine on Austria.[1]

The *Profit before extraordinary items*, which corresponds to the net income generated by ESM operations,[2] decreased by €7.3 million, to €42.3 million in 2018 from €49.6 million in 2017. Higher administrative expenses and the continued effect of the negative interest environment mainly drove this decrease, which was in part offset by a higher result on financial operations.

The interest income on debt securities held in the paid-in capital portfolio increased by €17.0 million due to more investments at higher yield compared to the cash remuneration rate. The *Net profit of financial operations* increased by €17.1 million to €44.3 million in 2018 from €27.2 million in 2017.

Operating costs, including depreciation of fixed assets, were €67.5 million compared to €61.3 million in 2017. The increase is mainly driven by additional staff cost as well as IT and advisory services. The ESM provides administrative services to the EFSF and therefore charges it service fees of €32.6 million (€30.9 million in 2017), which are recognised as *Other operating income*. The ESM continues to focus on budgetary discipline and effective cost control.

Outlook for 2019

Following the end of the programme for Greece in 2018, no further loan disbursements are foreseen in 2019. The ESM has actively diversified its investments and continues to look for additional measures to mitigate the impact of the negative yield environment, in line with its guidelines and its mandate. Nevertheless, the persistence of this environment will continue to affect the net income from ESM operations in 2019.

[1] This fine imposed on Austria is a sanction pursuant to Article 8(1) Regulation (EU) No. 1173/2011. Such sanctions are collected by the European Commission and are assigned to the ESM.

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

Balance sheet

As at 31 December 2018 (in €'000)

	Notes	31.12.2018	31.12.2017
ASSETS			
Cash in hand, balances with central banks and post office banks	4	65,245,717	74,288,120
Loans and advances to credit institutions			
(a) other loans and advances	5	1,291,715	369,174
		1,291,715	369,174
Loans and advances to euro area Member States	6	89,894,688	76,194,688
Debt securities including fixed-income securities	7		
(a) issued by public bodies		8,327,012	10,971,804
(b) issued by other borrowers		17,255,918	9,918,880
		25,582,930	20,890,684
Intangible assets	8	36	36
Tangible assets	9	7,207	4,664
Subscribed capital unpaid	2.15/15	624,250,300	624,250,300
Subscribed capital called but not paid	2.15/15	65,440	175,120
Prepayments and accrued income	10	777,929	820,833
Total assets		807,115,962	796,993,619
LIABILITIES			
Amounts owed to credit institutions	11	277,202	32,600
Debts evidenced by certificates	12		
(a) debt securities in issue		98,393,959	89,201,083
		98,393,959	89,201,083
Other liabilities	13	9,503	8,488
Accruals and deferred income	14/27	1,147,623	789,576
Total liabilities		99,828,287	90,031,747
SHAREHOLDERS' EQUITY			
Subscribed capital	2.15/15	704,798,700	704,798,700
Fair value reserve	7	140,174	99,119
Reserve fund	2.7.1/16	2,064,053	1,995,465
Profit for the financial year		284,748	68,588
Total shareholders' equity		707,287,675	706,961,872
Total equity and liabilities		807,115,962	796,993,619

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

Off-balance sheet

As at 31 December 2018 (in €'000)

	Notes	31.12.2018	31.12.2017
OFF-BALANCE SHEET			
Commitments	25		
(a) undisbursed loans to euro area Member States		-	45,774,339
		-	**45,774,339**
Other items	3.6/26		
(a) notional value of interest rate swaps		-	
- receivable		62,372,500	36,512,000
- payable		(62,372,500)	(36,512,000)
(b) notional value of cross-currency asset swaps		-	–
- receivable		11,267,278	5,788,261
- payable		(11,343,989)	(5,730,986)
(c) notional value of foreign exchange swaps		-	–
- receivable		484,896	2,305,628
- payable		(476,996)	(2,048,620)
(d) notional value of foreign exchange forwards		-	–
- receivable		-	1,363
- payable		-	(1,216)

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

Profit and loss account

For the financial year ending 31 December 2018 (in €'000)

	Notes	2018	2017
Interest receivable and similar income			
(a) on loans and advances to credit institutions		1,688	304
(b) on loans and advances to euro area Member States	17	1,189,777	938,764
(c) on debt securities including fixed-income securities	18	76,784	59,759
(d) on debts issued		102,783	95,744
(e) other	26	259,200	71,339
		1,630,232	**1,165,910**
Interest payable and similar charges			
(a) on cash and cash equivalents	19	(301,295)	(273,744)
(b) on loans to credit institutions		(2,450)	(329)
(c) on debts issued		(779,038)	(677,873)
(d) on debt securities including fixed-income securities	18	(7,880)	(7,937)
(e) other	26	(508,420)	(159,942)
		(1,599,083)	**(1,119,825)**
Commissions payable		**(19)**	**(26)**
Other operating income	20	**34,277**	**37,709**
Net profit on financial operations	21/27	**44,333**	**27,174**
General administrative expenses			
(a) staff costs	22	(32,431)	(31,166)
- wages and salaries		(23,419)	(22,841)
- social security		(9,012)	(8,325)
of which relating to pension		(7,924)	(7,074)
(b) other administrative expenses	23	(33,768)	(29,019)
		(66,199)	**(60,185)**
Value adjustments in respect of intangible and tangible assets		**(1,258)**	**(1,099)**
Profit before extraordinary items		**42,283**	**49,658**
Extraordinary income	24/27	**242,465**	**18,930**
Profit for the financial year		**284,748**	**68,588**

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

Statement of changes in equity

For the financial year ending 31 December 2018 (in €'000)

	Subscribed capital	Fair value reserve	Reserve fund	Profit brought forward	Profit for the financial year	Total
At 1 January 2017	704,798,700	183,194	1,426,701	-	568,764	706,977,359
Allocation of the profit of 2016	-	-	-	568,764	(568,764)	-
Allocation of profit brought forward to the reserve fund	-	-	568,764	(568,764)	-	-
Profit for the financial year	-	-	-	-	68,588	**68,588**
Change in fair value reserve	-	(84,075)	-	-	-	**(84,075)**
At 31 December 2017	704,798,700	99,119	1,995,465	-	68,588	706,961,872

	Subscribed capital	Fair value reserve	Reserve fund	Profit brought forward	Profit for the financial year	Total
At 1 January 2018	704,798,700	99,119	1,995,465	-	68,588	706,961,872
Allocation of the profit of 2017	-	-	-	68,588	(68,588)	-
Allocation of profit brought forward to the reserve fund	-	-	68,588	(68,588)	-	-
Profit for the financial year	-	-	-	-	284,748	**284,748**
Change in fair value reserve	-	41,055	-	-	-	**41,055**
At 31 December 2018	704,798,700	140,174	2,064,053	-	284,748	707,287,675

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

Statement of cash flows

For the financial year ending 31 December 2018 (in €'000)

	2018	2017
Cash flows from operating activities:		
Profit for the financial year	284,748	68,588
Adjustments for value adjustments in respect of tangible and intangible assets	1,258	1,099
Changes in tangible and intangible assets	(3,801)	(1,563)
Changes in other liabilities	1,015	(3,580)
Changes in accrued interest and interest received	(1,286,894)	(1,066,941)
Changes in prepayments	190,185	(274,121)
Changes in accruals and deferred income and interest paid	1,010,025	923,222
Interest received	1,139,613	971,712
Up-front service fee received	108,500	51,500
Interest paid	(760,478)	(647,877)
Net cash flow provided by operating activities	**684,171**	**22,039**
Cash flows from investing activities		
Change in debt securities including fixed-income securities	(4,651,191)	9,488,288
Change in loans and advances to credit institutions	(922,541)	(367,660)
Net loans disbursed during the year	(13,700,000)	(3,461,738)
Changes in amounts owed to credit institutions	244,602	32,600
Net cash flow provided/used in investing activities	**(19,029,130)**	**5,691,490**
Cash flows from financing activities		
Payment of capital	109,680	109,680
Changes in debt securities in issue	9,192,876	3,542,115
Net cash flow provided by financing activities	**9,302,556**	**3,651,795**
Net increase/decrease in cash and cash equivalents	(9,042,403)	9,365,324
Cash and cash equivalents at the beginning of the financial year	74,288,120	64,922,796
Cash and cash equivalents at the end of the financial year	**65,245,717**	**74,288,120**

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

Notes to the financial statements

1. General information

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

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

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

Lithuania joined the euro area on 1 January 2015. The Lithuanian parliament approved the ESM Treaty on 18 December 2014, and Lithuania officially became the ESM's 19th Member on 3 February 2015. The ESM Treaty was amended accordingly.

The present financial statements cover the period from 1 January 2018 to 31 December 2018, while comparative figures cover the period from 1 January 2017 to 31 December 2017.

On a proposal from the Managing Director, the Board of Directors adopted the financial statements on 26 March 2019 and authorised their submission to the Board of Governors for approval at their 13 June 2019 meeting.

1.1. General overview of the financial assistance programmes

The ESM is authorised to use 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 in the framework of a macroeconomic adjustment programme;
- purchase bonds or other debt securities in the primary debt market and conduct 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 ESM Members' governments;
- recapitalise systemic and viable euro area financial institutions directly under specific circumstances and as a last resort measure, following the 8 December 2014 ratification of a new instrument, the Direct Recapitalisation of Institutions.

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

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

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

- Commitment fee – the negative carry and issuance costs incurred in the period between the funding by the ESM and the disbursement to the beneficiary Member State, or for the period from the refinancing of the relevant funding instrument until its maturity. The commitment fee will be applied ex-post on the basis of the negative carry actually incurred.

- Service fee – the source of general revenues and resources to cover the ESM's operational costs. The service fee has two components:

  - up-front service fee (50 bps) generally deducted from the drawn amount,

  - annual service fee (0.5 bps) paid on the interest payment date.

- Margin – paid on the interest payment date. The margin charged differs across financial support instruments.

  - 10 bps for loans and primary market support facilities;

  - 5 bps for secondary market support facilities;

  - 35 bps for precautionary financial assistance;

  - 30 bps for financial assistance provided to an ESM Member for the recapitalisation of its financial institutions.

In addition, the ESM Pricing Policy includes specific elements tied to financial assistance for the Direct Recapitalisation of Institutions. This instrument is currently not used. The specific elements are detailed in the ESM Pricing Policy.

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

1.3. ESM financial assistance to Spain

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

This was the ESM's first financial assistance programme. It was also the first use of the instrument for recapitalising banks through loans granted to a government. No other lenders contributed.

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

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

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

On 7 July 2014, the ESM Board of Directors approved Spain's request to make an early repayment of €1.3 billion of its loan. This was the first time that a euro area country under a financial assistance programme made an early repayment request. The repayment took place on 8 July 2014 and was accompanied by a scheduled repayment of unused funds of €0.3 billion on 23 July 2014.

The ESM received two further early repayment requests from the Spanish authorities in 2015. The authorities submitted the first request on 27 February 2015. The ESM Board of Directors approved this €1.5 billion early repayment request on 9 March 2015 and the repayment took place on 17 March 2015. On 2 July 2015, the ESM Board of Directors approved another early repayment request from the Spanish government. This €2.5 billion repayment took place on 14 July 2015.

On 11 November 2016, the ESM received the fourth early repayment from Spain of €1 billion, which was approved by the ESM Board of Directors on 7 November 2016.

The ESM received two further early repayment requests from the Spanish authorities in 2017. On 14 June 2017, the ESM received the fifth early repayment from Spain of €1 billion, which was approved by the ESM Board of Directors on 1 June 2017. Subsequently on 5 October 2017, the ESM received the request for the sixth early repayment from Spain of €2 billion, which was approved by the ESM Board of Directors on 26 October 2017 and the repayment took place on 16 November 2017.

On 30 January 2018 Spain made the request for two further early repayments. On 23 February 2018 and 23 May 2018, the ESM received respectively the seventh and eighth early repayments from Spain of €2 billion and €3 billion, which were approved by the ESM Board of Directors on 8 February 2018. On 16 October 2018, the ESM received the ninth early repayment from Spain of €3 billion, which was approved by the ESM Board of Directors on 20 September 2018.

By 31 December 2018, Spain had, in total, repaid €17.6 billion of its financial assistance. All repayments were made in cash.

The outstanding nominal amount of loans granted to Spain as at 31 December 2018 is €23.7 billion (refer to note 6).

1.4. ESM financial assistance to Cyprus

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

The agreement on the macroeconomic adjustment programme led euro area members to decide on a financial assistance package of up to €10 billion. On 24 April 2013, the ESM Board of Governors decided to grant stability support to Cyprus. The ESM Board of Directors subsequently approved the Financial Assistance Facility Agreement (FFA) on 8 May 2013. The ESM disbursed €6.3 billion, and the International Monetary Fund (IMF) contributed around €1 billion. Cyprus exited successfully from its ESM programme on 31 March 2016.

According to the terms of the FFA, the first tranche of financial assistance was provided to Cyprus in two separate disbursements: the ESM disbursed the first €2 billion on 13 May 2013, and transferred the second in the amount of €1 billion on 26 June 2013. The second tranche of assistance, €1.5 billion of ESM floating rate notes, was disbursed on 27 September 2013. The Cypriot government used the notes for the recapitalisation of the cooperative banking sector. The third tranche of assistance, €0.1 billion, was disbursed on 19 December 2013. Disbursements of a total of €1.1 billion were made in 2014, and another €0.6 billion in 2015.

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

The outstanding nominal amount of loans granted to Cyprus as at 31 December 2018 is €6.3 billion (refer to note 6).

1.5. ESM financial assistance to Greece

The EFSF financial assistance programme for Greece expired on 30 June 2015. On 8 July 2015, the Greek government submitted a request for financial assistance to the Chairperson of the ESM Board of Governors. On 13 July 2015, the euro area ministers of finance agreed with Greece a set of urgent prior actions in order to start negotiations for a new programme under the ESM. The ESM Board of Governors finally approved a new programme on 19 August 2015. The ESM Boards of Governors and Directors approved also the financial assistance facility agreement (FFA) with Greece. The ESM was authorised to provide Greece with up to €86 billion in financial assistance over three years. Greece successfully exited its programme in August 2018.

The ESM programme focussed on four key areas: restoring fiscal sustainability, safeguarding financial stability, boosting growth, competitiveness and investment, and reforming the public administration. The funds available under the FFA were earmarked to cover needs related to debt servicing, banking sector recapitalisation and resolution and budget financing. To return its economy to growth and make its debt burden more sustainable, the Greek government committed to a series of far-reaching economic reforms.

On 20 August 2015, the ESM approved the first tranche of €26 billion in financial assistance for Greece, divided in two sub-tranches. This decision followed the ESM Board of Directors' approval of the FFA, specifying the terms of the financial assistance. The Board of Directors also decided to immediately disburse €13 billion in cash to Greece. This was the first disbursement under the first sub-tranche, of €16 billion, to be used for budget financing and debt servicing needs. The second sub-tranche, of €10 billion, was immediately created in ESM floating rate notes and held in a segregated account. These funds were designated to cover the Greek banking sector's potential resolution and recapitalisation costs, with release decisions to be taken on a case-by-case basis.

On 23 November 2015, the Board of Directors authorised the disbursement of €2 billion in cash to Greece as the second disbursement under the €16 billion sub-tranche approved in August 2015. This decision followed the Greek government's completion of the first set of reform milestones. This disbursement was primarily used for debt servicing.

On 1 December 2015, the Board of Directors decided to release €2.7 billion to Greece to recapitalise Piraeus Bank. Subsequently, on 8 December 2015, the Board of Directors decided to release €2.7 billion to Greece to recapitalise the National Bank of Greece. The ESM transferred these amounts under the €10 billion sub-tranche, held in ESM notes in a segregated account. The availability period of the remaining €4.6 billion expired on 31 January 2016.

On 22 December 2015, the Board of Directors approved the disbursement of €1 billion to Greece as the third and final disbursement under the €16 billion sub-tranche agreed in August 2015. This decision followed the Greek government's completion of the second set of reform milestones. This disbursement was also used for debt servicing.

On 17 June 2016, the Board of Directors approved the disbursement of €7.5 billion to Greece as the first disbursement under the second tranche of €10.3 billion. This disbursement was used for debt servicing and to help clear domestic arrears.

On 25 October 2016, the Board of Directors approved the disbursement of €2.8 billion to Greece as the second disbursement under the second tranche of €10.3 billion. This €2.8 billion disbursement consisted of two parts: €1.1 billion was approved for release following the full implementation of a set of 15 milestones by the Greek authorities, and was used for debt servicing. A further €1.7 billion was disbursed to a dedicated account for clearing arrears after a positive assessment of the clearance of net arrears by Greece.

On 20 January 2017, the ESM Board of Directors approved three schemes aimed at reducing interest rate risk for Greece. The first was a bond exchange, where floating rate notes disbursed by the ESM to Greece for bank recapitalisation were exchanged for fixed coupon notes. The second scheme allowed the ESM to enter into swap arrangements to reduce the risk that Greece would have to pay a higher interest rate on its loans when market rates start rising. The third scheme, which entailed issuing long-term bonds that closely matched the maturity of the Greek loans, was replaced by additional swap arrangements.

On 20 February 2017, the ESM received a loan repayment of €2 billion from the Greek government. The repayment was a contractual obligation with the ESM and followed the sale of an asset by one of the banks that took part in the 2015 banking recapitalisation, financed with ESM loans.

On 7 July 2017, the ESM Board of Directors approved the first disbursement of the €7.7 billion under the third tranche of €8.5 billion. Out of this amount, €6.9 billion was used for debt servicing needs and €0.8 billion for arrears clearance.

On 26 October 2017, the ESM Board of Directors approved the disbursement of €0.8 billion to Greece for the clearance of arrears.

On 27 March 2018, the ESM Board of Directors approved the fourth tranche of €6.7 billion to Greece for debt service, domestic arrears clearance and for establishing a cash buffer. The ESM Board of Directors approved the release of the first disbursement under this tranche amounting to €5.7 billion, which took place on 28 March 2018.

On 14 June 2018, the ESM Board of Directors authorised the release of the remaining amount of the fourth tranche of ESM financial assistance, approved on 27 March 2018. The disbursement of €1 billion was used for the clearance of arrears.

On 6 August 2018 the ESM disbursed the fifth and final tranche of ESM financial assistance for Greece, amounting to €15 billion. Out of this tranche, €9.5 billion was used for building up Greece's cash buffer and €5.5 billion was used for debt service. After the disbursement, the cash buffer reached around €24 billion. That sum will cover around 22 months of Greece's financing needs after the end of the programme on 20 August 2018.

On 20 August 2018 Greece officially concluded its three-year ESM financial assistance programme with a successful exit. This follows the disbursement of a total of €61.9 billion by the ESM over three years in support of macroeconomic adjustment and bank recapitalisation in Greece. The remaining €24.1 billion available under the maximum €86 billion programme volume was not utilised and automatically cancelled.

The outstanding nominal amount of loans granted to Greece as at 31 December 2018 is €59.9 billion (refer to note 6).

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 Directive 86/635/EEC of the Council of the European Communities of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions, as amended by Directive 2001/65/EC of 27 September 2001, by Directive 2003/51/EC of 18 June 2003 and by Directive 2006/46/EC of 14 June 2006 (the 'Directives'). Their specific application by the ESM is described in the subsequent notes.

The ESM prepares an annual report in respect of each financial year and submits it to the Board of Governors for approval at its annual meeting. The annual report contains a description of the policies and activities of the ESM, the financial statements for the relevant financial year, the report of the external auditors in respect of their audit in respect of said financial statements, and the report of the Board of Auditors in respect of said financial statements pursuant to Article 24(6) of the ESM By-Laws.

The preparation of financial statements in conformity with the Directives requires the use of certain critical accounting estimates. It also requires management[3] to exercise its judgement in applying the ESM's accounting policies. Areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the financial statements are disclosed in Note 2.3.

[3] 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.

2.2. 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 recognised in the fair value reserve.

2.3. Use of estimates

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

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

The ESM reviews its loans and advances to beneficiary Member States at each reporting date, to assess whether a value adjustment is required (see also Note 2.8.). Such assessment requires judgement by the management and the ESM governing bodies, consistent with the ESM's mandate as a permanent crisis resolution mechanism that aims at supporting beneficiary Member States' return to public financial stability.

No value adjustment was required as at 31 December 2018 and 2017, thus none has been recorded.

2.4. Foreign currency translation

The ESM uses the euro (€) as the unit of measure of its accounts 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 on the dates of the initial transactions. Non-monetary items measured at fair value in a foreign currency are translated using the exchange rates on the date when the fair value was determined.

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

2.5. Derivative financial instruments

The ESM uses derivatives instruments for risk management purposes only. Cross-currency asset swaps and foreign exchange swaps and forwards are used to hedge the currency risk into euro[4] (refer to Note 3.3.2), and interest rate swaps to manage the interest rate risk exposure (refer Note 3.3.1).

All derivatives transactions are booked at notional as off-balance sheet items at the date of the transaction.

[4] As per Article 2 (5) of the ESM Guidelines on the Investment Policy, any currency risk shall be hedged into euro to ensure a limited remaining foreign exchange risk for the ESM.

2.5.1. Foreign exchange swaps and forwards

For the management of the paid-in capital portfolio activities, the ESM enters into foreign exchange swap and forwards in order to hedge back in euro the cash flow's currency risk of a non-euro denominated investment with a residual maturity of less than 2 years. Ongoing forward and spot exchange transactions are converted at the spot rates of exchange prevailing at reporting date and neutralised in 'Accruals and deferred income' or 'Prepayments and accrued income'. The spread between the spot amount and forward settlement amount is linearly amortised through the profit and loss account in 'Interest receivable and similar income' or 'Interest payable and similar charges'. On the maturity date, the parties exchange the initial principal amounts at the contractual exchange rate. The difference between the spot and the forward rate at maturity is recognised under the caption 'Interest receivable and similar income' or 'Interest payable and similar charges' in the profit and loss account.

2.5.2. Cross-currency asset swaps and interest rate swaps

The ESM enters into cross-currency asset swaps in order to cover floating or fixed rates in different currencies in its paid-in capital portfolio as well as issuances in USD. In a cross-currency asset swap, payments are exchanged based on either two floating reference rates, one floating rate and one fixed rate, or two fixed rates, each with a corresponding notional amount denominated in a different currency from a given security (the asset). Notional amounts are exchanged on the effective date and the maturity date. Ongoing forward and spot exchange transactions are converted at the spot rates of exchange prevailing on the balance sheet date and neutralised in 'Accruals and deferred income' or 'Prepayments and accrued income'.

The spread between the spot amount and forward settlement amount is linearly amortised through the profit and loss account in 'Interest receivable and similar income' or 'Interest payable and similar charges'. Interest payments exchanged are also included in 'Interest receivable and similar income' or 'Interest payable and similar charges' in the profit and loss account.

An interest rate swap is a contract under which floating-rate interest is exchanged for fixed-rate interest or vice-versa. Interest received and paid under interest rate swaps are accrued and reported under 'Interest receivable and similar income' or 'Interest payable and similar charges' in the profit and loss account.

On the maturity date the difference between the payable and the receivable interest is recognised under the caption 'Interest receivable and similar income' or 'Interest payable and similar charges' in the profit and loss account.

All interest rate swaps and cross-currency asset swaps are concluded under the contractual framework of ISDA swap agreements and Credit Support Annexes (CSA), which specify the conditions of exposure collateralisation, in order to offset mark-to-market fluctuations on a daily basis through the exchange of collateral. These are generally accepted and practised contract types (see also Note 3.6.3).

The cash collateral received or posted is reported under 'Amounts owed to credit institutions' or 'Loans and advances to credit institutions'.

2.6. 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 liabilities on the balance sheet.

2.7. Debt securities including fixed-income securities

The ESM has established the following portfolios for the management of its financial assets:

2.7.1. Paid-in capital and reserve fund investments

The ESM's capital provisions are laid down in Chapter 3 of the ESM Treaty. The initial aggregate nominal value of paid-in shares was €80 billion and has been increased to €80.5 billion due to the accession of Latvia and Lithuania. The net income generated by ESM operations and the proceeds of the financial sanctions received from the ESM Members under the multilateral surveillance procedure, the excessive deficit procedure, and the macro-economic imbalances procedure established under the Treaty on the Functioning of the European Union (TFEU) are put aside in a reserve fund, in accordance with Chapter 5 of the ESM Treaty.

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

According to the investment principles defined in the Investment Guidelines, an appropriate level of diversification of the investment portfolios shall be maintained to reduce the ESM's overall risk. Diversification shall be attained through allocation between various asset classes, geographical areas (and notably supranational institutions, and issuers outside the euro area), issuers and instruments.

According to the Investment Guidelines, any currency risk shall be hedged into euro to ensure a limited remaining foreign exchange risk for the ESM. Derivatives shall be used for risk management purposes only (refer to Note 3.6.2).

The paid-in capital and the reserve fund investments are managed in the same portfolio. As the Investment Guidelines specify, the paid-in capital is divided in Short-term tranche and the Medium and long-term tranche. The assets of the reserve fund are invested in full in the short-term tranche:

Short-term tranche

The tranche with the highest liquidity requirements is the short-term tranche. The main objective of the short-term tranche is to enable the ESM to face any temporary disbursement to cover any liquidity shortfall, due to a non-payment by a beneficiary Member State. 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- and long-term tranche

The main objective of the medium- and long-term tranche is to ensure the ESM's financial strength. This tranche is managed to enhance the return of the paid-in capital and is subject to the constraints specified in the Investment Guidelines. This tranche is also mainly invested in liquid instruments.

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

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

2.7.2. Liquidity buffer investments

The ESM's borrowing strategy must meet several objectives and principles to comply with the purpose established in Article 3 of the ESM Treaty. The general borrowing strategy must therefore offer the possibility to react rapidly to unexpected market developments, including the build-up of liquidity buffers and ensure market access, even in a difficult market environment.

As per the ESM Investment Guidelines, the management of the liquidity buffer follows the same investment restrictions as the short-term tranche of the paid-in capital described in Note 2.7.1.

2.7.3. Determination of fair value

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

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

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

2.8. 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 on an active market. Loans and advances are initially recognised at their net disbursement amounts, and subsequently measured at amortised cost.

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

Specific value adjustments are accounted for in the profit and loss account in respect of loans and advances presenting objective evidence that all or part of their outstanding balance is not recoverable (refer to Note 2.3) and are deducted from the corresponding asset in the balance sheet.

The underlying securities purchased under the agreements to resell ("reverse repos") are not recognised on the balance sheet while the consideration paid is recorded as loans and advances to credit institutions as appropriate and carried at the amounts of the cash advanced on the balance sheet. The counterparties enter into an irrevocable commitment to complete the operation on a date and a price fixed at the outset. The difference between the sale and the repurchase price is treated as interest and recognised over the life of the agreement (refer to Note 5).

2.9. Intangible assets

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

2.10. Tangible assets

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

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

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

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

2.11. Prepayments and accrued income

Prepayments and accrued income are related either to invoices received and paid in advance for expenses related to subsequent reporting periods, or to any income related to the reporting period which will only be received in the course of a subsequent financial year. It includes the spot revaluation, the spread amortisation and also the accrued interest income of ongoing derivative transactions (refer to Note 2.5).

2.12. Amounts owed to credit institutions

Amounts owed to credit institutions are presented in the financial statements at their redemption amounts. Transaction costs and premiums/discounts are amortised in the profit and loss account through interest payable and similar charges/income. Interest expense on amounts owed to credit institutions are also included in 'Interest payable and similar charges' in the profit and loss account.

The underlying securities sold under the repurchase agreements ("repos") are not recognised on the balance sheet while the consideration received is recorded as amounts owed to credit institutions as appropriate and carried at the amounts of the cash received on the balance sheet. The counterparties enter into an irrevocable commitment to complete the operation on a date and a price fixed at the outset. The difference between the sale and the repurchase price is treated as interest and recognised over the life of the agreement (refer to Note 11).

2.13. 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.

2.14. Provisions

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

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

2.15. Subscribed capital

On 31 December 2018, the ESM's shareholders were the 19 euro area Member States. In accordance with Article 8 of the ESM Treaty, the authorised capital is €704.8 billion, which is divided into 7,047,987 shares, with a nominal value of €100,000 each. The authorised capital was subscribed by the shareholders according to the contribution key provided in Article 11 and calculated in Annex I of the ESM Treaty. The authorised capital is divided into paid-in shares and callable shares, where the total aggregate nominal value of paid-in shares is €80.5 billion.

In accordance with Article 4 of Directive 86/635/EEC as amended, the authorised capital stock 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'.

2.16. Accruals and deferred income

Accruals and deferred income are related to payments received before the balance sheet date but not exclusively related to the reporting period, together with any charges which, though relating to the financial year in question will only be paid in a subsequent financial year. It also includes the spot revaluation and spread amortisation of ongoing derivative transactions (refer to Note 2.5).

2.17. Interest receivable and payable

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

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 applied to discount the future cash flows for the purpose of measuring the impairment loss.

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

2.18. Employee benefits

The ESM operates a pension plan with defined contribution characteristics funded through payments to an external insurance company. This insurance scheme also covers the risk of death and disability.

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

2.19. Compensation payments from ESM Members

Payments received from a Member State as compensation for expenses or losses (refer to Note 27) incurred in a previous period are recorded as extraordinary income in profit or loss of the period in which they become receivable. Such compensation payments are made with a view to capital preservation and are granted on a case-by-case basis, subject to conditions not controlled by the ESM. Therefore, a receivable is evidenced either through a notification of the payment or the respective transfer of money.

2.20. Taxation

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

3. Risk management

This section presents information about the approach of the ESM to risk management and risk controls and its risk exposure, in relation to the primary risks associated with its use of financial instruments. These are:

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

3.1. Risk management organisation

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

According to the ESM's High Level Principles for Risk Management, the targeted risk appetite should preserve the ESM's funding capacity, ensure the highest creditworthiness, and avoid unexpected capital calls. The Risk Policy describes the risk appetite and the framework for identifying, assessing, monitoring and managing risks consistent with the risk appetite. It covers all ESM financial and non-financial risks, and both on- and, if applicable, off-balance sheet items. The risk profile is defined by a set of limits to curtail all types of risks within the risk appetite. The ESM does not aim at generating profit on financial support granted to beneficiary Member States and does not provide incentives for speculative exposures on its investment portfolio.

The ESM operates under the principles of the three lines of defence approach: departments and business functions assume direct responsibility for day-to-day risk management. All staff are responsible for ensuring that risks relating to their operations are identified, followed up, and reported to Risk & Compliance. Risk & Compliance exercises central oversight of risk and ensures that all business functions, comprehensively and consistently, implement the risk management framework.

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

The Chief Risk Officer is the head of the Risk & Compliance team and reports directly to the Managing Director. The Chief Risk Officer is responsible and accountable for informing the Managing Director on all risks which the institution may face to ensure enforcement and oversight. The Managing Director reports risk-related information to the Board of Directors, principally through the Board Risk Committee.

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

3.2. Credit risk

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

Given the nature of the ESM's mandate, where credit risk from lending arises as a result of support to beneficiary Member States under a FFA, the credit risk in the ESM's lending exposure is accepted. Note 3.2.4 below further describes the ESM's treatment of loans to euro area Member States.

3.2.1. Exposure to credit risk without taking into account any collateral or other credit enhancements

The following table shows the direct exposure to credit risk for the components of the balance sheet. For on-balance-sheet positions, these exposures are based on net carrying amounts as reported on the balance sheet.

(in €'000)	Exposure 31.12.2018	Exposure 31.12.2017
Cash in hand, balances with central banks and post office banks	65,245,717	74,288,120
Loans and advances to credit institutions	1,291,715	369,174
Debt securities including fixed-income securities	25,582,930	20,890,684
On balance sheet credit risk exposure	**92,120,362**	**95,547,978**
Exposure at default on derivatives[1]	1,582,340	1,162,930
Credit risk exposure	**93,702,702**	**96,710,908**

[1] The cash-collateral is included in the calculation of the Exposure at Default and reported as exposure in the On balance sheet items.

This table does not include the loans and advances to euro area Member States as the ESM does not manage the credit risk on beneficiary Member States, while it monitors its exposures through the Early Warning System, as described in Note 3.2.4.

3.2.2. Risk profile of counterparties and issuers

The following tables show the breakdown of the financial assets by credit rating. For '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. If issuance ratings are unavailable, the issuers rating is presented. For other financial assets, the credit ratings of the counterparties are presented.

These tables do not include the breakdown of the 'Loans and advances to euro area Member States', as the ESM risk function does not manage the inherent risk of non-payment of the beneficiary Member States, as described in Note 3.2.

(in €'000)	Credit rating[1]	Clean carrying value 31.12.2018
Cash in hand, balances with central banks and post office banks	not rated[2]	65,243,078
	AA	2,639
Loans and advances to credit institutions	not rated[3]	263,462
	AA	1,603
	AA-	227,480
	A+	108,140
	A	691,030
Debt securities including fixed-income securities	not rated	-
	AAA	14,233,063
	AA+	1,504,603
	AA	2,622,472
	AA-	1,916,056
	A+	283,318
	A	5,023,418
Total		**92,120,362**

[1] Based on the lowest rating provided by the major rating agencies (Moody's, Standard & Poor's or Fitch) presented based on the rating scale used by Fitch.
[2] "Not rated" means balances placed with Eurosystem central banks, which are not rated.
[3] "Not rated" means balances (Reverse Repos) placed with Eurex Clearing, which is not rated.

(in €'000)	Credit rating[1]	Clean carrying value 31.12.2017
Cash in hand, balances with central banks and post office banks	not rated[2]	74,285,731
	AA	2,389
Loans and advances to credit institutions	not rated[2]	-
	AA	101,514
	AA-	62,120
	A+	55,600
	A	149,940
Debt securities including fixed-income securities	not rated	-
	AAA	12,129,744
	AA+	1,246,238
	AA	1,566,053
	AA-	1,244,951
	A+	177,703
	A	4,525,995
Total		**95,547,978**

[1] Based on the lowest rating provided by the major rating agencies (Moody's, Standard & Poor's or Fitch) presented based on the rating scale used by Fitch.
[2] "Not rated" means balances placed with Eurosystem central banks, which are not rated.

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

The ESM invests in assets that fulfil the high credit risk standards set by the Investment Guidelines require. To mitigate the credit risk on its investments, the ESM has also established a detailed structure of credit limits. The ESM measures credit exposures and monitors limit compliance daily.

3.2.4. Credit risk in relation to loans to euro area Member States

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

The determination and close monitoring of debt sustainability and conditionality attached to all financial assistance to beneficiary Member States, as negotiated with the European Commission in liaison with the European Central Bank (ECB) and whenever possible the IMF, are aimed at addressing and substantially reducing credit risk. It is the mutual understanding of the ESM Members that ESM loans enjoy preferred creditor status that is similar to the IMF, while accepting preferred creditor status of the IMF over the ESM. This does not apply to ESM loans for programmes that existed when the ESM Treaty was signed. Moreover, for the financial assistance to Spain it was decided to not apply the preferred creditor status. The ESM has implemented an early warning procedure as requested by the ESM Treaty to monitor the ability of the beneficiary Member State to repay its obligations. Findings are summarised in a regular report analysed by the Internal Risk Committee.

The ESM provided financial assistance to Spain for the recapitalisation of its financial sector which must be repaid by 2027. The ESM also provided financial assistance to Cyprus, which implemented a macroeconomic adjustment programme. Furthermore, starting from August 2015, the ESM provided financial assistance to Greece. Note 6 provides a breakdown of all disbursed amounts, as well as the movements during the year.

From an investor's point of view, the ESM's capital structure and the possibility of capital calls mitigate the risk arising from beneficiary Member States' non-payment and potential losses from other risks. Under Article 9 of the ESM Treaty, there are different instances when a capital call can be made to cover losses or avert non-payment, as described in Note 15. These mechanisms provide the strongest possible assurance that ESM debt securities will be serviced and repaid.

3.3. Market risk

Market risk is the risk of loss arising from changes in the value of financial assets and liabilities due to fluctuations in interest rates, foreign exchange rates, and other factors affecting the price of securities / financial instruments (e.g. credit spreads and basis risk).

3.3.1. Interest rate risk

Interest rate risk is defined as the potential for loss arising from adverse movements in interest rates. The main sources of interest rate risk include asset or liability re-pricing following market movements, yield curve shifts, and changes in interest rate credit spread.

Structural interest rate risk is defined as the risk of a mismatch between the interest rate re-pricing of loans granted to beneficiary Member States and of its funding raised through bills and bond issuances. The exposure to interest rate risk arises from differences in repricing and maturity characteristics of the different asset, liability, and hedging instruments.

All funding costs arising from refinancing risk are passed through to beneficiary Member States under financial assistance, as defined by the ESM Pricing Policy.

Non-structural 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 investment portfolio. Non-structural interest rate risk is monitored and controlled on a daily basis through risk indicators and stress tests. Duration bands, cumulated and partial sensitivities, 1 day Value at Risk with a 99% level of confidence are part of the daily measures that frame the interest rate risk potential exposure. To complement these measures, a series of stress tests with flattening, steepening and parallel shifts of all or a selected number of interest rate curves is daily processed as part of the risk report.

In addition, Capital volatility and Capital preservation measures frame and limit the Short Term and the Medium/Long Term tranches interest rate risk exposures in line with the Risk Appetite of the Institution as described and published in the ESM Investment Guidelines.

Capital volatility is defined as a yearly limit to market losses over a one-year horizon for the Medium/Long Term Tranche. The 1 year VaR 99% should be lower than 3% of the market value of the tranche.

Capital preservation is defined as protecting shareholders from losses on the Paid-in-Capital, which currently stands at €80.5 billion. The market value of the STT (including the Reserve Fund) and MLTT investment portfolios shall not fall below this value over a relevant investment horizon, for a high level of confidence. The relevant investment horizon is set in relation to the nature of each portfolio:

- For the Short-Term Tranche, the capital shall be preserved at a one-year horizon, for a high level of confidence.
- For the Medium/Long-Term Tranche, the capital shall be preserved at a three-year horizon for a high level of confidence.

To assess capital preservation with a 'high level of confidence', a vast array of scenarios of interest rate movements are used to forecast the market value of the STT and the MLTT investments over the relevant investment horizons.

Scenario analyses are different to sensitivity analysis as they assess the impact of a range of different setups and correlations over a multi-year period, while sensitivity analysis assesses the linear and instantaneous impact to a given change in interest rates.

These scenarios, developed in cooperation with Investment and Treasury, are agreed at the Internal Risk Committee (IRC) and endorsed by the Board Risk Committee (BRC).

Capital preservation scenario analysis results are reported at least once a year to IRC/BRC and for any major investment portfolio strategy proposal to the IMC.

Derivatives contracted with commercial banks are fully collateralised, thanks to the exchange of cash and highly rated securities, regulated by collateral agreements (ISDA and Credit Support Annex – CSA - standards).

The interest rate risk on the ESM investment portfolio is managed prudently to support the ESM's financial stability mandate, which requires the ESM to maintain financial soundness including in period of market stress.

3.3.2. Currency risk

Currency risk is defined as the potential for loss arising from changes in exchange rates and shall be minimised by limiting net currency exposure, in line with the risk appetite of the institution.

The ESM is exposed to currency risk whenever there is a currency mismatch between its assets and liabilities. The potential source of currency risk is the non-euro investments made in the investment portfolios and funding activities.

In 2018, the ESM had investment activities in foreign currency assets, mainly Swedish krona, Japanese yen and US dollars. In compliance with the Article 2 (5) of the ESM Investment Guidelines, any currency risk is hedged into euros to ensure a limited remaining foreign exchange risk for the ESM (refer to Note 3.6).

The ESM also has funding activities in US dollars. In 2017, the ESM decided to broaden its investor base and spread its funding liquidity risk across the euro and dollar markets. On 24 October 2017, the ESM priced its inaugural US dollar issue, raising $3 billion. On 16 October 2018, the ESM raised $3 billion by issuing a new 2-year bond, its second deal in the dollar market. The ESM does not run currency risk through these transactions, as it has hedged the proceeds back into euros (refer to Note 3.6.1.2).

As it is the case for Interest Rate Swaps, operations contracted with commercial banks are fully collateralised, thanks to the exchange of cash and highly rated securities, regulated by collateral agreements (ISDA and Credit Support Annex – CSA – standards).

31 December 2018 (in €'000)	Euro (EUR)	Japanese Yen (JPY)	US Dollar (USD)	Swedish Krone (SEK)	Other currencies	Total
ASSETS						
Cash in hand, balances with central banks and post office banks	65,245,717	-	-	-	-	**65,245,717**
Loans and advances to credit institutions	1,291,715	-	-	-	-	**1,291,715**
Loans and advances to euro area Member States	89,894,688	-	-	-	-	**89,894,688**
Debt securities including fixed-income securities	18,765,766	4,968,264	1,366,833	183,994	298,073	**25,582,930**
Prepayments and accrued income	722,022	5,624	49,288	995	-	**777,929**
Total financial assets	**175,919,908**	**4,973,888**	**1,416,121**	**184,989**	**298,073**	**182,792,979**
LIABILITIES						
Amounts owed to credit institutions	277,202	-	-	-	-	**277,202**
Debt securities in issue	93,168,174	-	5,225,785	-	-	**98,393,959**
Other liabilities	9,503	-	-	-	-	**9,503**
Accruals and deferred income	970,757	113,256	60,095	3,515	-	**1,147,623**
Total financial liabilities	**94,425,636**	**113,256**	**5,285,880**	**3,515**	**-**	**99,828,287**
Shareholders' equity[1]	82,971,935	-	-	-	-	-
Total shareholders' equity[2]	**82,971,935**	**-**	**-**	**-**	**-**	**82,971,935**
Off-balance sheet derivatives	**1,372,710**	**(4,843,353)**	**3,871,878**	**(180,403)**	**-**	**220,832**
Net of financial position	**(104,953)**	**17,279**	**2,119**	**1,071**	**298,073**	**213,589**

[1] Excluding subscribed capital unpaid and subscribed capital called but not paid
[2] Shareholder equity has no defined maturity

04

31 December 2017 (in €'000)	Euro (EUR)	Japanese Yen (JPY)	US Dollar (USD)	Swedish Krone (SEK)	Other currencies	Total
ASSETS						
Cash in hand, balances with central banks and post office banks	74,288,120	-	-	-	-	**74,288,120**
Loans and advances to credit institutions	369,174	-	-	-	-	**369,174**
Loans and advances to euro area Member States	76,194,688	-	-	-	-	**76,194,688**
Debt securities including fixed-income securities	15,981,269	4,536,847	181,947	190,621	-	**20,890,684**
Prepayments and accrued income	801,314	7,921	10,562	1,036	-	**820,833**
Total financial assets	**167,634,565**	**4,544,768**	**192,509**	**191,657**	**-**	**172,563,499**
LIABILITIES						
Amounts owed to credit institutions	32,600	-	-	-	-	**32,600**
Debt securities in issue	86,711,327	-	2,489,756	-	-	**89,201,083**
Other liabilities	8,488	-	-	-	-	**8,488**
Accruals and deferred income	677,335	82,069	25,180	4,992	-	**789,576**
Total financial liabilities	**87,429,750**	**82,069**	**2,514,936**	**4,992**	**-**	**90,031,747**
Shareholders' equity[1]	82,536,452	-	-	-	-	**82,536,452**
Total shareholders' equity[2]	**82,536,452**	**-**	**-**	**-**	**-**	**82,536,452**
Off-balance sheet derivatives	**2,639,552**	**(4,454,205)**	**2,317,018**	**(187,936)**	**-**	**314,429**
Net of financial position	**307,915**	**8,494**	**(5,409)**	**(1,271)**	**-**	**309,729**

[1] Excluding subscribed capital unpaid and subscribed capital called but not paid
[2] Shareholder equity has no defined maturity.

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 subscribed capital. The ESM monitors its liquidity position on a daily basis by assessing its funding liquidity risk and market liquidity risk.

Funding liquidity risk is defined as the risk of loss arising from difficulty in securing the necessary funding, or from a significantly higher cost of funding than normal levels, due to a deterioration of the ESM's creditworthiness, or at a time of unfavourable market conditions (such as periods of high stress). Funding liquidity risk is managed by maintaining a permanent market access to a wide investor base with different funding instruments, 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. The market presence in the USD market which started in 2017 reduces further the funding liquidity risk as it gives access to additional investors in a different market. At the end of December 2018, the ESM's liquidity buffer stood at €8.4 billion (2017: €13.1 billion).

Market liquidity risk is defined as the potential for loss arising from a position that cannot easily be liquidated without significantly and negatively influencing its market price. Market liquidity risk is minimised by investing in high credit quality liquid assets, ensuring the ESM does not hold a significant portion of a security issuance and adopting adequate measurements that allow the timely detection of liquidity deteriorations.

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

31 December 2018 (in €'000)	Less than 3 months	From 3 months to 1 year	From 1 to 5 years	More than 5 years	Total
ASSETS					
Cash in hand, balances with central banks and post office banks	65,245,717	-	-	-	**65,245,717**
Loans and advances to credit institutions	1,291,715	-	-	-	**1,291,715**
Loans and advances to euro area Member States	-	-	-	89,894,688	**89,894,688**
Debt securities including fixed-income securities	433,795	834,702	15,611,898	8,702,535	**25,582,930**
Prepayments and accrued income	95,838	567,510	-	114,581	**777,929**
Total financial assets	**67,067,065**	**1,402,212**	**15,611,898**	**98,711,804**	**182,792,979**
LIABILITIES					
Amounts owed to credit institutions	277,202	-	-	-	**277,202**
Debt securities in issue	11,897,405	9,012,566	32,216,672	45,267,316	**98,393,959**
Other liabilities	9,503	-	-	-	**9,503**
Accruals and deferred income	325,499	445,425	158,941	217,758	**1,147,623**
Total financial liabilities	**12,509,609**	**9,457,991**	**32,375,613**	**45,485,074**	**99,828,287**
Shareholders' equity[1]	-	-	-	82,971,935	**82,971,935**
Total shareholders' equity[2]	**-**	**-**	**-**	**82,971,935**	**82,971,935**
Net of financial position	**54,557,456**	**(8,055,779)**	**(16,763,715)**	**(29,745,205)**	**(7,243)**

31 December 2017 (in €'000)	Less than 3 months	From 3 months to 1 year	From 1 to 5 years	More than 5 years	Total
ASSETS					
Cash in hand, balances with central banks and post office banks	74,288,120	-	-	-	**74,288,120**
Loans and advances to credit institutions	369,174	-	-	-	**369,174**
Loans and advances to euro area Member States	-	-	-	76,194,688	**76,194,688**
Debt securities including fixed-income securities	64,902	1,542,344	16,039,694	3,243,744	**20,890,684**
Prepayments and accrued income	77,758	592,843	42,048	108,184	**820,833**
Total financial assets	**74,799,954**	**2,135,187**	**16,081,742**	**79,546,616**	**172,563,499**
LIABILITIES					
Amounts owed to credit institutions	32,600	-	-	-	**32,600**
Debt securities in issue	8,982,989	15,917,806	26,510,038	37,790,250	**89,201,083**
Other liabilities	8,488	-	-	-	**8,488**
Accruals and deferred income	256,026	319,934	149,157	64,459	**789,576**
Total financial liabilities	**9,280,103**	**16,237,740**	**26,659,195**	**37,854,709**	**90,031,747**
Shareholders' equity[1]	-	-	-	82,536,452	**82,536,452**
Total shareholders' equity[2]	**-**	**-**	**-**	**82,536,452**	**82,536,452**
Net of financial position	**65,519,851**	**(14,102,553)**	**(10,577,453)**	**(40,844,545)**	**(4,700)**

[1] Excluding subscribed capital unpaid and subscribed capital called but not paid
[2] The shareholder's equity has no defined maturity

3.5. Operational risk

Operational risk is defined as the potential loss or damage, 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. The categorisation of the ESM operational risks is based on guidance from the Basel Committee on Banking Supervision, as follows:

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

Management has no tolerance for material operational risks, including those originating from third party/vendor engagements, which may result in the ESM's inability to effectively fulfil its mandate, or in significant loss and/or reputational damage. No material operational risk losses were identified in 2018.

All departments are responsible for the proactive mitigation of operational risks, and for the robustness of the controls in their processes. If operational risk events occur, they are reported to the Risk & Compliance Department through an internal operational risk register. Formal escalation procedures have been established involving the Internal Risk Committee and the Board Risk Committee to ensure the active involvement of senior management and, where necessary, the Board of Directors.

All departments, with support from the Operational Risk function, perform a root-cause analysis of operational risk events and implement improvements, as necessary, in the underlying processes and controls to reduce the probability of reoccurrence. This approach is complemented by annual risk control self-assessments for each department, and bi-annual business continuity risk assessment, to identify and assess the ESM's top operational risks (based on potential likelihood and impact). The Risk & Compliance Department monitors these risks and reports on them to the Internal Risk Committee and to the Board Risk Committee.

3.6. Derivatives

The ESM uses derivative instruments as described in Note 2.5 for risk management purposes only and this as part of its investment and funding activities. In 2015, the ESM entered into foreign exchange derivative transactions such as foreign exchange swaps and forward contracts to cash flow hedge the currency risk related to short-term non-euro denominated investments. Since 2017, the ESM also entered into interest rate swaps to manage globally the Investment portfolio's interest rate exposure and to decrease the interest rate volatility on the Greek debt. Longer term cross-currency asset swaps were contracted as well to cash flow hedge longer term non-euro denominated investments and to hedge in euro the issuances in USD.

On 31 December 2018, the derivative instruments had a maximum maturity up to 30 years (2017: maximum maturity up to 30 years) and were concluded with euro area central banks, international financial institutions and commercial banks.

3.6.1. Funding derivatives

The derivatives used in the context of funding are:

- Interest rate swaps;
- Cross-currency asset swaps.

3.6.1.1. Interest rate swaps

Interest rate swaps exchange future interest payments, usually a fixed interest rate for a floating rate, or vice versa, to reduce or increase exposure to fluctuations in interest rates based on a specified notional amount.

On 20 January 2017, the ESM Board of Directors approved three schemes aimed at reducing interest rate risk for Greece. Amongst others, it allowed the ESM to enter into interest rate swap arrangements that aimed to stabilise the ESM's overall cost of funding for Greece, i.e. to reduce the risk that Greece would have to pay a higher interest rate on its loans when market rates start rising.

The following table shows the interest rate swaps according to their notional amount and fair value. The notional amounts are disclosed off balance sheet.

Interest rate swaps (in €'000)	31.12.2018	31.12.2017
Notional amount (receivable)	60,000,000	36,311,000
Positive fair value (i.e. net discounted value)	284,496	69,074
Negative fair value (i.e. net discounted value)	(1,139,657)	(254,001)

3.6.1.2. Cross-currency asset swaps

Cross-currency asset swaps are derivative contracts under which it is agreed by two counterparties to exchange interest payments (fixed-fixed, fixed-float and float-float) and principal denominated in two different currencies. In a cross-currency asset swap, interest payments and principal in one currency are exchanged for equally valued principal and interest payments in a different currency. Interest payments are exchanged at fixed intervals during the life of the contract. Starting in 2017 and continuing in 2018, the ESM broadened its investor base and spread its funding liquidity risk across the euro and dollar markets (refer to Note 3.3.2). The ESM hedges the currency risk of these transactions in US dollars using cross-currency asset swaps contracts.

The following table shows the cross-currency swaps according to their notional amount and fair value. The notional amounts are disclosed off balance sheet.

Cross-currency assets swaps (in €'000)	31.12.2018	31.12.2017
Notional amount (receivable)	5,240,175	2,501,459
Positive fair value (i.e. net discounted value)	88,315	-
Negative fair value (i.e. net discounted value)	-	(69,361)

3.6.2. Investment derivatives

The derivatives used in the context of investment activity are:

- Interest rate swaps;
- Cross-currency asset swaps;
- Foreign exchange (FX) swaps and forwards.

3.6.2.1. Interest rate swaps

Interest rate swaps exchange future interest payments, usually a fixed interest rate for a floating rate, or vice versa, to reduce or increase exposure to fluctuations in interest rates based on a specified notional amount.

Starting in 2017, the ESM has used interest rate swaps to manage the interest rate risk of the paid-in capital portfolio.

The following table shows the interest rate swaps according to their notional amount and fair value. The notional amounts are disclosed off balance sheet.

Interest rate swaps (in €'000)	31.12.2018	31.12.2017
Notional amount (receivable)	2,372,500	201,000
Positive fair value (i.e. net discounted value)	4,056	263
Negative fair value (i.e. net discounted value)	(33,685)	(189)

3.6.2.2. Foreign exchange (FX) swaps and forwards

In a foreign exchange swap, two parties agree to exchange the principal amounts of two different currencies at the beginning of the transaction and the amounts to exchange at maturity. A foreign exchange forward is essentially a hedging tool that involves the purchase or sale of a currency on a future date at a predetermined exchange rate without any upfront payment.

Starting from 2015, the ESM has invested limited amounts in short-term (with a maximum maturity of 2 years) assets denominated in a foreign currency.

The following tables shows the foreign exchange swaps and forwards according to their notional amount and fair value. The notional amounts are disclosed off balance sheet.

Foreign exchange swaps (in €'000)	31.12.2018	31.12.2017
Notional amount (receivable)	484,896	2,305,628
Positive fair value (i.e. net discounted value)	8,039	262,957
Negative fair value (i.e. net discounted value)	-	(2,354)

Foreign exchange forwards (in €'000)	31.12.2018	31.12.2017
Notional amount (receivable)	-	1,363
Positive fair value (i.e. net discounted value)	-	151

3.6.2.3. Cross-currency asset swaps

Cross-currency asset swaps are derivatives contracts under which it is agreed by two counterparties to exchange interest payments (fixed-fixed, fixed-float and float-float) and principal denominated in two different currencies. In a cross-currency asset swap, interest payments and principal in one currency are exchanged for equally valued principal and interest payments in a different currency. Interest payments are exchanged at fixed intervals during the life of the contract.

Starting in 2017, the ESM has invested in non-euro denominated securities with longer maturities.

The following table shows the cross currency-asset swaps according to their notional amount and fair value. The notional amounts are disclosed off balance sheet.

Cross-currency asset swaps (in €'000)	31.12.2018	31.12.2017
Notional amount (receivable)	6,027,103	3,286,802
Positive fair value (i.e. net discounted value)	8,942	54,231
Negative fair value (i.e. net discounted value)	(326,163)	(18,278)

3.6.3. Credit risk on derivatives

Credit risk exposure for derivatives lies in the loss that the ESM would incur if a counterparty were unable to honour its contractual obligations. There are three main forms of credit risk related to derivatives. First, for cross-currency asset swaps and FX swaps, the exchange of notional at beginning and maturity of a trade can lead to settlement risk. Second, the default of a derivative counterparty over the life of the derivative can lead to a loss, if changes in the mark-to-market (MtM) value of the position are not fully collateralised at the time of default. Third, when using derivatives, the ESM is exposed to replacement risk. This is the loss the ESM would face if it would have to replace a trade from a defaulted counterparty with a new counterparty.

With regard to derivative transactions, the ESM has contracted FX and interest rate derivative transactions since 2015. Operations contracted with commercial banks are fully collateralised, thanks to the exchange of cash and highly rated securities. The exposure after collateral posting is then limited to the intraday market movements and their impact on the market value of the exposure and on the posted collateral value.

The ESM put in place a series of procedures to safeguard against losses arising from the use of such instruments.

- Contractual framework

All of the ESM's derivatives transactions are governed by best practice International Swaps and Derivatives Association (ISDA) agreements. In addition, for all commercial counterparties, the ESM has put in place Credit Support Annexes (CSAs) for over-the-counter transactions, which specify the conditions of exposure collateralisation on a daily basis.

- Counterparty selection

The minimum rating of a counterparty at the outset of a trade is at least BBB+/Baa1. The ESM has the right of early termination if the rating of the counterparty drops below a certain level. The ESM sets derivative limits per counterparty, based on forecasted exposure at default. The ESM uses the Basel Committee's recommended standardised approach for measuring counterparty credit risk exposures to quantify exposure at default per counterparty. The methodology also considers potential losses that could occur in between the default and the replacement of the cancelled trade.

- Collateralisation

Exposures towards commercial banks (exceeding limited thresholds) are fully collateralized by cash and/or securities. On a daily basis, the ESM monitors and values its derivative positions, and calls or releases collateral, as applicable. Below a certain counterparty credit rating, the ESM receives an additional independent amount from counterparties, in line with recommendations of the Basel Committee.

- Settlement limits

The ESM limits settlement risk for bilateral FX swaps and cross-currency asset swaps through settlement limits for counterparties, based on these counterparties' creditworthiness. Settlement risk is measured and monitored on a daily basis.

In the context of the United Kingdom leaving the EU, the ESM has reviewed any exposures that it has towards counterparties based in the United Kingdom and has taken preventive measures, as applicable, to mitigate the impact on the ESM's business operations.

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

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

(in €'000)	31.12.2018	31.12.2017
Current account balances with euro area central banks [(1)]	65,243,078	74,285,731
Current account balances with other banks[(2)]	2,639	2,389
Total cash in hand, balances with central banks and post office banks	**65,245,717**	**74,288,120**

[(1)] In 2017, the ESM opened two new current accounts at the European Central Bank.
[(2)] The ESM holds current accounts for operational purposes with a state-owned bank as well as clearing accounts with custodians. No current account is held with post office banks.

The cash balance with euro area central banks is comprised of paid-in capital, the reserve fund and the liquidity buffer investment.

5. Loans and advances to credit institutions

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

(in €'000)	31.12.2018	31.12.2017
Money market deposits with other banks	-	100,000
Cash collateral provided	1,026,650	267,660
Reverse repos	263,462	-
Other deposits	1,603	1,514
Total loans and advances to credit institutions	**1,291,715**	**369,174**

Other deposits consist entirely of the lease guarantee deposit in relation to the ESM rental agreement. The cash collateral provided for, relates entirely to derivatives transactions. The reverse repurchase agreements (`reverse repo`) are transactions traded on regulated markets.

6. Loans and advances to euro area Member States

In accordance with Article 9 of the ESM Treaty, the Board of Governors may decide to grant financial assistance in the form of a loan to an ESM Member (refer to Note 27).

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

(in €'000)	No. of loans	Nominal amount	Clean carrying value as at 31 December 2018
Loans to euro area Member States			
- to Spain	5	23,721,460	23,721,460
- to Cyprus	9	6,300,000	6,300,000
- to Greece	11	59,873,228	59,873,228
Total	**25**	**89,894,688**	**89,894,688**

(in €'000)	No. of loans	Nominal amount	Clean carrying value as at 31 December 2017
Loans to euro area Member States			
- to Spain	5	31,721,460	31,721,460
- to Cyprus	9	6,300,000	6,300,000
- to Greece	8	38,173,228	38,173,228
Total	**22**	**76,194,688**	**76,194,688**

The following table shows the movements of the loans to euro area Member States during 2017 and 2018:

(in €'000)	
1 January 2017 balance	**72,732,950**
New disbursements	8,500,000
- to Greece	*8,500,000*
Early repayments	(5,029,200)
- from Spain	*(3,000,000)*
- from Greece	*(2,029,200)*
Premiums/discounts amortization	(9,062)
31 December 2017 balance	**76,194,688**

(in €'000)	
1 January 2018 balance	**76,194,688**
New disbursements	21,700,000
- to Greece	*21,700,000*
Early repayments	*(8,000,000)*
- from Spain	*(8,000,000)*
Premiums/discounts amortization	-
31 December 2018 balance	**89,894,688**

7. Debt securities including fixed-income securities

The following table shows the details of the paid-in-capital portfolio debt securities valuation:

(in €'000)	Clean amortised cost	Unrealised gains	Clean fair (carrying) value	Nominal amount
31.12.2018	25,442,756	140,174	25,582,930	25,155,501
31.12.2017	20,791,565	99,119	20,890,684	20,402,049

On 31 December 2018, the clean amortised cost of the debt securities was €25.4 billion (31 December 2017: €20.8 billion), against a clean fair value of €25.6 billion (31 December 2017: €20.9 billion). 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 invested in debt securities, the ESM has an established investment policy setting strict eligibility criteria that restrict investment to issuers with the highest credit quality. The Risk & Compliance Department defines a limit structure to mitigate the maximum exposure per issuer.

On 31 December 2018, the debt securities including fixed income securities of the paid-in capital portfolio include investments in money market securities that are not listed on regulated markets with a total clean fair value of €89.2 million (nil as of 31 December 2017). Their fair values are determined using valuation techniques, as disclosed in Note 2.7.3. All other securities are listed on regulated markets and the fair values of these assets are based on quoted market prices.

The ESM invests in debt securities issued by public bodies and other issuers. Public bodies cover central banks, central governments, regional governments, local governments, supranational institutions and governmental agencies. On 31 December 2018, debt securities issued by public bodies amounted to €8.3 billion. (31 December 2017: €11.0 billion), while debt securities issued by other borrowers amounted to €17.3 billion (31 December 2017: €9.9 billion).

Starting from 2015, the ESM has invested part of the paid-in capital portfolio in short-term assets denominated in a foreign currency (refer to Note 3.3.2). Starting in 2017, the ESM has invested in non-euro denominated securities with longer maturities.

8. Intangible assets

The following table shows the movements of intangible assets during 2018:

(in €'000)	Software	Total intangible assets
Historical cost		
1 January 2018 balance	168	168
Additions	27	27
31 December 2018 balance	**195**	**195**
Accumulated amortisation		
1 January 2018 balance	(132)	(132)
Amortisation	(27)	(27)
31 December 2018 balance	**(159)**	**(159)**
Net book value		
31 December 2018 balance	**36**	**36**
31 December 2017 balance	**36**	**36**

9. Tangible assets

The following table shows the movements of tangible assets during 2018:

(in €'000)	Fixtures and fittings	Furniture and office equipment	Total tangible assets
Historical cost			
1 January 2018 balance	6,628	1,960	8,588
Additions	3,159	615	3,774
Disposals	-	-	-
31 December 2018 balance	**9,787**	**2,575**	**12,362**
Accumulated depreciation			
1 January 2018 balance	(2,312)	(1,612)	(3,924)
Depreciation	(994)	(237)	(1,231)
Of the disposed assets	-	-	-
31 December 2018 balance	**(3,306)**	**(1,849)**	**(5,155)**
Net book value			
31 December 2018 balance	**6,481**	**726**	**7,207**
31 December 2017 balance	**4,316**	**348**	**4,664**

10. Prepayments and accrued income

The following table shows the breakdown of prepayments and accrued income. The receivables are due within a year:

(in €'000)	31.12.2018	31.12.2017
Interest receivable on:		
- Debt securities including fixed-income securities	78,620	78,988
- Loans and advances to euro area Member States	431,006	283,441
- Loans and advances to credit institutions	92	8
Amounts charged to the EFSF for administrative services (Note 20/27)	9,789	10,025
Commitment fee receivable	75	10,845
Prepayments	115,372	845
Amounts from sanctions to Member States[1]	26,820	18,930
Other[2]	116,155	417,751
Total prepayments and accrued income	**777,929**	**820,833**

[1] The ESM received the payments of certain sanctions paid by its Member States (refer to Note 24).
[2] "Other" represents the spot revaluation, spread amortisation and accrued income of ongoing derivative transactions (refer to Note 2.11).

11. Amounts owed to credit institutions

On 31 December 2018, the €277.2 million of amounts owed to credit institutions were composed of cash collateral received for the derivatives €14.2 million (31 December 2017: €32.6 million) and repurchase agreement ("repo") €263 million (31 December 2017: €nil).

12. Debts evidenced by certificates

The following table discloses the details of debt securities in issue outstanding on 31 December 2018, together with the coupon rates and due dates..

Type of funding/ Programmes	ISIN code	Nominal amount (in €'000)	Issue date	Maturity date	Coupon
Long-term Funding	EU000A1U9803	3,000,000	20/11/2013	20/11/2023	2.125%
Long-term Funding	EU000A1U9803[(2)]	990,750	27/06/2014	20/11/2023	2.125%
Long-term Funding	EU000A1U9811	6,000,000	04/03/2014	04/03/2021	1.375%
Long-term Funding	EU000A1U9829	3,000,000	14/05/2014	15/10/2019	0.875%
Long-term Funding	EU000A1U9829[(2)]	2,000,000	28/07/2015	15/10/2019	0.875%
Long-term Funding	EU000A1U9894	3,000,000	23/09/2015	23/09/2025	1.000%
Long-term Funding	EU000A1U9894[(2)]	999,850	29/09/2016	23/09/2025	1.000%
Long-term Funding	EU000A1U9902	3,000,000	20/10/2015	20/10/2045	1.750%
Long-term Funding	EU000A1U9910	4,000,000	03/11/2015	03/11/2020	0.100%
Long-term Funding	EU000A1U9910[(2)]	992,750	11/03/2016	03/11/2020	0.100%
Long-term Funding	EU000A1U9928	1,500,000	17/11/2015	17/11/2036	1.625%
Long-term Funding	EU000A1U9928[(2)]	1,000,000	31/03/2016	17/11/2036	1.625%
Long-term Funding	EU000A1U9936	1,000,000	01/12/2015	01/12/2055	1.850%
Long-term Funding	EU000A1U9936[(2)]	1,000,000	01/03/2016	01/12/2055	1.850%
Long-term Funding	EU000A1U9944	3,000,000	02/03/2016	02/03/2026	0.500%
Long-term Funding	EU000A1U9944[(2)]	2,500,000	19/07/2016	02/03/2026	0.500%
Long-term Funding	EU000A1U9951	3,000,000	22/04/2016	22/04/2024	0.125%
Long-term Funding	EU000A1U9951[(2)]	961,100	28/07/2016	22/04/2024	0.125%
Long-term Funding	EU000A1U9951[(2)]	989,750	11/11/2016	22/04/2024	0.125%
Long-term Funding	EU000A1U9969	3,000,000	03/05/2016	03/05/2032	1.125%
Long-term Funding	EU000A1U9969[(2)]	1,000,000	18/10/2016	03/05/2032	1.125%
Long-term Funding	EU000A1U9977	2,500,000	19/07/2016	18/07/2042	0.875%
Long-term Funding	ESMNBOND0001[(3)]	80,000	22/01/2016	22/01/2041	1.572%
Long-term Funding	ESMNBOND0002[(3)]	30,000	10/02/2016	11/02/2041	1.360%
Long-term Funding	ESMNBOND0003[(3)]	25,000	09/03/2016	09/03/2056	1.559%
Long-term Funding	ESMNBOND0004[(3)]	25,000	09/03/2016	09/03/2056	1.559%
Long-term Funding	ESMNBOND0005[(3)]	25,000	31/03/2016	22/03/2046	1.316%
Long-term Funding	ESMNBOND0006[(3)]	30,000	11/04/2016	11/04/2046	1.220%
Long-term Funding	ESMNBOND0007[(3)]	40,000	03/08/2016	03/08/2056	1.156%
Long-term Funding	ESMNBOND0008[(3)]	150,000	09/08/2016	09/08/2056	1.150%
Long-term Funding	ESMNBOND0009[(3)]	50,000	19/08/2016	19/08/2053	1.025%
Long-term Funding	ESMNBOND0010[(3)]	50,000	19/08/2016	18/08/2056	1.064%
Long-term Funding	ESMNBOND0011[(3)]	50,000	19/09/2016	19/09/2051	1.030%
Long-term Funding	EU000A1U9985	3,000,000	18/10/2016	18/10/2022	0.000%
Long-term Funding	EU000A1U9985[(2)]	996,500	16/11/2017	18/10/2022	0.000%
Long-term Funding	ESMNBOND0012[(3)]	50,000	19/10/2016	19/10/2054	1.145%
Long-term Funding	ESMNBOND0013[(3)]	40,000	19/10/2016	19/10/2056	1.125%
Long-term Funding	ESMNBOND0014[(3)]	25,000	27/10/2016	27/10/2056	1.086%
Long-term Funding	EU000A1Z99A1	3,500,000	01/02/2017	02/11/2046	1.800%
Long-term Funding	EU000A1Z99A1[(2)]	1,500,000	14/06/2017	02/11/2046	1.800%

Continued from the previous page

Type of funding/ Programmes	ISIN code	Nominal amount (in €'000)	Issue date	Maturity date	Coupon
Long-term Funding	EU000A1Z99B9	3,000,000	14/03/2017	15/03/2027	0.750%
Long-term Funding	ESMNBOND0015[3]	110,000	14/03/2017	14/03/2047	1.800%
Long-term Funding	ESMNBOND0016[3]	40,000	31/03/2017	30/03/2057	1.850%
Long-term Funding	ESMNBOND0017[3]	100,000	21/04/2017	21/04/2047	1.573%
Long-term Funding	XS1704649158[4]	2,620,087	31/10/2017	03/11/2022	2.125%
Long-term Funding	ESMNBOND0018[3]	60,000	27/11/2017	27/11/2057	1.591%
Long-term Funding	ESMNBOND0019[3]	25,000	11/12/2017	11/12/2057	1.530%
Long-term Funding	ESMNBOND0020[3]	50,000	12/12/2017	12/12/2057	1.505%
Long-term Funding	ESMNBOND0021[3]	50,000	19/12/2017	19/12/2057	1.442%
Long-term Funding	EU000A1U9985[2]	998,550	23/02/2018	18/10/2022	0.000%
Long-term Funding	EU000A1Z99D5	2,000,000	23/05/2018	23/05/2033	1.200%
Long-term Funding	EU000A1Z99B9[2]	1,500,000	19/06/2018	15/03/2027	0.750%
Long-term Funding	EU000A1Z99E3	4,000,000	31/07/2018	31/07/2023	0.100%
Long-term Funding	EU000A1U9936	750,000	05/09/2018	01/12/2055	1.850%
Long-term Funding	EU000A1Z99F0	3,250,000	05/09/2018	05/09/2028	0.750%
Long-term Funding	EU000A1Z99G8	3,000,000	16/10/2018	17/01/2022	0.000%
Long-term Funding	XS1896646137[4]	2,620,087	23/10/2018	23/10/2020	3.000%
Short-term Funding	EU000A1Z98Y3[1]	1,922,350	19/07/2018	24/01/2019	N/A
Short-term Funding	EU000A1Z9808[1]	1,999,250	23/08/2018	21/02/2019	N/A
Short-term Funding	EU000A1Z9824[1]	1,970,200	20/09/2018	21/03/2019	N/A
Short-term Funding	EU000A1Z9832[1]	1,999,750	04/10/2018	10/01/2019	N/A
Short-term Funding	EU000A1Z9840[1]	1,998,400	18/10/2018	18/04/2019	N/A
Short-term Funding	EU000A1Z9857[1]	1,998,300	08/11/2018	07/02/2019	N/A
Short-term Funding	EU000A1Z9865[1]	1,998,900	22/11/2018	23/05/2019	N/A
Short-term Funding	EU000A1Z9873[1]	1,999,500	06/12/2018	07/03/2019	N/A
Total		98,161,074			

[1] Zero-coupon bond
[2] Tap issue
[3] N-bond with technical ISIN: the ESM issued its first N-bond (Namensschuldverschreibungen) in 2016. N-Bonds are privately placed, long-term funding instruments that are neither centrally cleared nor listed.
[4] USD denominated debt securities issued starting with 2017.

The following table discloses the details of debt securities in issue outstanding on 31 December 2017, together with the coupon rates and due dates..

Type of funding/ Programmes	ISIN code	Nominal amount (in €'000)	Issue date	Maturity date	Coupon
Long-term Funding	EU000A1U9803	3,000,000	11/20/2013	11/20/2023	2.125%
Long-term Funding	EU000A1U9803[(2)]	990,750	6/27/2014	11/20/2023	2.125%
Long-term Funding	EU000A1U98Z1	7,000,000	10/15/2013	10/15/2018	1.250%
Long-term Funding	EU000A1U9811	6,000,000	3/4/2014	3/4/2021	1.375%
Long-term Funding	EU000A1U9829	3,000,000	5/14/2014	10/15/2019	0.875%
Long-term Funding	EU000A1U9829[(2)]	2,000,000	7/28/2015	10/15/2019	0.875%
Long-term Funding	EU000A1U9886	6,000,000	9/15/2015	12/17/2018	0.050%
Long-term Funding	EU000A1U9894	3,000,000	9/23/2015	9/23/2025	1.000%
Long-term Funding	EU000A1U9894[(2)]	999,850	9/29/2016	9/23/2025	1.000%
Long-term Funding	EU000A1U9902	3,000,000	10/20/2015	10/20/2045	1.750%
Long-term Funding	EU000A1U9910	4,000,000	11/3/2015	11/3/2020	0.100%
Long-term Funding	EU000A1U9910[(2)]	992,750	3/11/2016	11/3/2020	0.100%
Long-term Funding	EU000A1U9928	1,500,000	11/17/2015	11/17/2036	1.625%
Long-term Funding	EU000A1U9928[(2)]	1,000,000	3/31/2016	11/17/2036	1.625%
Long-term Funding	EU000A1U9936	1,000,000	12/1/2015	12/1/2055	1.850%
Long-term Funding	EU000A1U9936[(2)]	1,000,000	3/1/2016	12/1/2055	1.850%
Long-term Funding	EU000A1U9944	3,000,000	3/2/2016	3/2/2026	0.500%
Long-term Funding	EU000A1U9944[(2)]	2,500,000	7/19/2016	3/2/2026	0.500%
Long-term Funding	EU000A1U9951	3,000,000	4/22/2016	4/22/2024	0.125%
Long-term Funding	EU000A1U9951[(2)]	961,100	7/28/2016	4/22/2024	0.125%
Long-term Funding	EU000A1U9951[(2)]	989,750	11/11/2016	4/22/2024	0.125%
Long-term Funding	EU000A1U9969	3,000,000	5/3/2016	5/3/2032	1.125%
Long-term Funding	EU000A1U9969[(2)]	1,000,000	10/18/2016	5/3/2032	1.125%
Long-term Funding	EU000A1U9977	2,500,000	7/19/2016	7/18/2042	0.875%
Long-term Funding	ESMNBOND0001[(3)]	80,000	1/22/2016	1/22/2041	1.572%
Long-term Funding	ESMNBOND0002[(3)]	30,000	2/10/2016	2/11/2041	1.360%
Long-term Funding	ESMNBOND0003[(3)]	25,000	3/9/2016	3/9/2056	1.559%
Long-term Funding	ESMNBOND0004[(3)]	25,000	3/9/2016	3/9/2056	1.559%
Long-term Funding	ESMNBOND0005[(3)]	25,000	3/31/2016	3/22/2046	1.316%
Long-term Funding	ESMNBOND0006[(3)]	30,000	4/11/2016	4/11/2046	1.220%
Long-term Funding	ESMNBOND0007[(3)]	40,000	8/3/2016	8/3/2056	1.156%
Long-term Funding	ESMNBOND0008[(3)]	150,000	8/9/2016	8/9/2056	1.150%
Long-term Funding	ESMNBOND0009[(3)]	50,000	8/19/2016	8/19/2053	1.025%
Long-term Funding	ESMNBOND0010[(3)]	50,000	8/19/2016	8/18/2056	1.064%
Long-term Funding	ESMNBOND0011[(3)]	50,000	9/19/2016	9/19/2051	1.030%
Long-term Funding	EU000A1U9985	3,000,000	10/18/2016	10/18/2022	0.000%
Long-term Funding	EU000A1U9985[(2)]	996,500	11/16/2017	10/18/2022	0.000%
Long-term Funding	ESMNBOND0012[(3)]	50,000	10/19/2016	10/19/2054	1.145%
Long-term Funding	ESMNBOND0013[(3)]	40,000	10/19/2016	10/19/2056	1.125%
Long-term Funding	ESMNBOND0014[(3)]	25,000	10/27/2016	10/27/2056	1.086%
Long-term Funding	EU000A1Z99A1	3,500,000	2/1/2017	11/2/2046	1.800%
Long-term Funding	EU000A1Z99A1[(2)]	1,500,000	6/14/2017	11/2/2046	1.800%
Long-term Funding	EU000A1Z99B9	3,000,000	3/14/2017	3/15/2027	0.750%

Continued from the previous page

Type of funding/ Programmes	ISIN code	Nominal amount (in €'000)	Issue date	Maturity date	Coupon
Long-term Funding	ESMNBOND0015[3]	110,000	3/14/2017	3/14/2047	1.800%
Long-term Funding	ESMNBOND0016[3]	40,000	3/31/2017	3/30/2057	1.850%
Long-term Funding	ESMNBOND0017[3]	100,000	4/21/2017	4/21/2047	1.573%
Long-term Funding	XS1704649158[4]	2,501,459	10/31/2017	11/3/2022	2.125%
Long-term Funding	ESMNBOND0018[3]	60,000	11/27/2017	11/27/2057	1.591%
Long-term Funding	ESMNBOND0019[3]	25,000	12/11/2017	12/11/2057	1.530%
Long-term Funding	ESMNBOND0020[3]	50,000	12/12/2017	12/12/2057	1.505%
Long-term Funding	ESMNBOND0021[3]	50,000	12/19/2017	12/19/2057	1.442%
Short-term Funding	EU000A1Z9790[1]	1,500,000	7/20/2017	1/25/2018	N/A
Short-term Funding	EU000A1Z98B1[1]	1,484,400	8/24/2017	2/22/2018	N/A
Short-term Funding	EU000A1Z98D7[1]	1,499,950	9/21/2017	3/22/2018	N/A
Short-term Funding	EU000A1Z98E5[1]	1,496,600	10/5/2017	1/11/2018	N/A
Short-term Funding	EU000A1Z98F2[1]	1,423,600	10/19/2017	4/19/2018	N/A
Short-term Funding	EU000A1Z98G0[1]	1,496,700	11/9/2017	2/8/2018	N/A
Short-term Funding	EU000A1Z98H8[1]	1,493,450	11/23/2017	5/24/2018	N/A
Short-term Funding	EU000A1Z98J4[1]	1,497,800	12/7/2017	3/8/2018	N/A
Total		**88,929,659**			

[1] Zero-coupon bond
[2] Tap issue
[3] N-bond with technical ISIN: the ESM issued its first N-bond (Namensschuldverschreibungen) in 2016. N-Bonds are privately placed, long-term funding instruments that are neither centrally cleared nor listed.
[4] USD denominated debt securities issued starting with 2017

The following table shows the movements of the debt securities in issue in 2017 and 2018:

(in €'000)	
1 January 2017 balance	**85,658,968**
Issuance during the period	51,736,229
Maturities during the year	(48,083,455)
Premiums/discounts amortisation	(110,659)
31 December 2017 balance	**89,201,083**

(in €'000)	
1 January 2018 balance	**89,201,083**
Issuances during the year	63,821,416
Maturities during the year	(54,631,850)
Exchange adjustments	118,056
Premiums/discounts amortization	**(114,746)**
31 December 2018 balance	**98,393,959**

All debt securities in issue at 31 December 2017 and 31 December 2018 are issued under English law as the governing law, except the N-bonds which are issued under German law.

13. Other liabilities

On 31 December 2018, the other liabilities were composed of suppliers' invoices and staff cost related payables which were not yet settled, amounting to €9.5 million (31 December 2017: €8.5 million).

14. Accruals and deferred income

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

(in €'000)	31.12.2018	31.12.2017
Interest payable cash and cash equivalents	24,100	25,776
Interest payable on loans to credit institutions	306	244
Interest payable on debts evidenced by certificates	282,193	251,670
Deferred income on up-front service fee	262,179	224,203
Other[1]	578,845	287,683
Total accruals and deferred income	1,147,623	789,576

[1] "Other" represents the spot revaluation and spread amortisation of ongoing derivative transactions (refer to Note 2.15 and 2.5).

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

15. Subscribed capital

(in €'000)	Subscribed capital	Subscribed, uncalled capital	Subscribed, called capital
1 January 2017	704,798,700	(624,250,300)	80,548,400
Subscription to the authorised capital	-	-	-
Authorised capital calls	-	-	-
31 December 2017	704,798,700	(624,250,300)	80,548,400

(in €'000)	Subscribed capital	Subscribed, uncalled capital	Subscribed, called capital
1 January 2018	704,798,700	(624,250,300)	80,548,400
Subscription to the authorised capital	-	-	-
Authorised capital calls	-	-	-
31 December 2018	704,798,700	(624,250,300)	80,548,400

On 31 December 2018, the ESM's shareholders were the 19 euro area Member States. The contribution key for subscribing to the ESM authorised capital is based on the key as per the Annex 1 of the ESM Treaty.

Latvia joined the ESM on 13 March 2014 and subscribed to an authorised capital of 19,353 shares with a par value of €100,000 each, representing €1.9 billion of subscribed capital of which €221.2 million was called. On 31 December 2018 Latvia had made all instalments for the payment of paid-in shares. Lithuania joined the ESM on 3 February 2015 and subscribed to an authorised capital of 28,634 shares with a par value of €100,000 each, representing €2.9 billion of subscribed capital, of which €327.2 million was called. On 31 December 2018 Lithuania had made the first four instalments for the payment of paid-in shares in the amount of €261.8 million.

On 31 December 2018, the authorised capital was €704.8 billion (31 December 2017: €704.8 billion), divided into 7,047,987 shares (31 December 2017: 7,047,987 shares), with a par value of €100,000 each, and is split according to the contribution key. Out of the total authorised capital, €624.3 billion (31 December 2017: €624.3 billion) is callable. On 31 December 2018, the called subscribed capital amounted to €80.5 billion (31 December 2017: €80.5 billion), of which €80.5 billion (31 December 2017: €80.4 billion) is paid.

ESM Members 31 December 2018	ESM Key (%)	Number of shares	Subscribed capital (in €'000)	Subscribed capital called and paid (in €'000)
Kingdom of Belgium	3.4534	243,397	24,339,700	2,781,680
Federal Republic of Germany	26.9616	1,900,248	190,024,800	21,717,120
Republic of Estonia	0.1847	13,020	1,302,000	148,800
Ireland	1.5814	111,454	11,145,400	1,273,760
Hellenic Republic	2.7975	197,169	19,716,900	2,253,360
Kingdom of Spain	11.8227	833,259	83,325,900	9,522,960
French Republic	20.2471	1,427,013	142,701,300	16,308,720
Italian Republic	17.7917	1,253,959	125,395,900	14,330,960
Republic of Cyprus	0.1949	13,734	1,373,400	156,960
Republic of Latvia	0.2746	19,353	1,935,300	176,960
Republic of Lithuania	0.4063	28,634	2,863,400	196,320
Grand Duchy of Luxembourg	0.2487	17,528	1,752,800	200,320
Malta	0.0726	5,117	511,700	58,480
Kingdom of the Netherlands	5.6781	400,190	40,019,000	4,573,600
Republic of Austria	2.7644	194,838	19,483,800	2,226,720
Portuguese Republic	2.4921	175,644	17,564,400	2,007,360
Republic of Slovenia	0.4247	29,932	2,993,200	342,080
Slovak Republic	0.8184	57,680	5,768,000	659,200
Republic of Finland	1.7852	125,818	12,581,800	1,437,920
Total	100.00	7,047,987	704,798,700	80,482,960

On 31 December 2018, the subscribed capital called but not paid amounted to €0.1 billion and was related to Lithuania (31 December 2017: €0.2 billion related to Latvia and Lithuania).

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

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

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

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

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

iii. An emergency capital call, under Article 9(3) of the ESM Treaty to avoid default of an ESM payment obligation to its creditors.

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

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

16. Reserve fund

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

On 15 June 2018, the Board of Governors decided at their annual general meeting to appropriate the net result of 2017 amounting to €68.6 million to the reserve fund. As a result the outstanding balance of the reserve fund as at 31 December 2018 is €2,064 million (2017: €1,995 million).

17. 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:

(in €'000)	2018	2017
Interest on loans[(1)]	1,119,179	877,608
Amortisation loan premium	-	(9,062)
Amortisation up-front service fee	70,523	59,373
Commitment fee	75	10,845
Total interest and similar income	**1,189,777**	**938,764**

[(1)] The interest on loans comprises base rate interest representing the cost of funding of the ESM, the margin and the annual service fee as the ESM Pricing Policy defines them.

18. Net interest receivable and similar income on debt securities including fixed-income securities

The geographical breakdown of the interest receivable and similar income on debt securities including fixed-income securities is detailed as follows:

(in €'000)	2018	2017
Euro area issuers	32,728	22,734
Other EU issuers	6,433	8,359
EU supranational organisations	5,318	5,034
Total European Union	**44,479**	**36,127**
Other non-EU issuers	16,657	12,089
Other supranational organisations	7,768	3,606
Total outside the European Union	**24,425**	**15,695**
Total interest and similar income	**68,904**	**51,822**

19. Interest payable and similar charges on cash and cash equivalents

On 31 December 2018, the interest payable and similar charges on cash and cash equivalents represent negative interest paid on the balances with central banks and amounts to €301.3 million (2017: €273.7 million). Since February 2017, the ESM is being charged a negative interest rate (-0.40% per annum) on the cash held at Eurosystem central banks. The relevant ESM Members agreed to compensate the ESM, under certain conditions, for a part of the negative interest charged by their national central banks (refer to Note 27).

20. Other operating income

The EFSF has asked the ESM to provide administrative and other support services to assist it in performing its activities. To formalise this cooperation, the ESM and EFSF entered into a service level agreement from 1 January 2013. Under the agreement's terms, the ESM is entitled to charge the EFSF service fees to achieve a fair cost-sharing arrangement. For the services during the financial year 2018, the ESM charged the EFSF €32.6 million (2017: €30.9 million), from which €9.8 million had yet to be paid on the balance sheet date (refer to Note 10).

In 2018, the internal tax on salaries retained from staff members amounts to €1.7 million (2017: €1.7 million).

In 2017, the cumulated internal tax on salaries retained from staff members amounting to €5.0 million for the years 2013 to 2016 and €1.7 million for 2017 has been transferred to "Other operating income". Salaries are recorded on a gross basis within Staff costs. In accordance with Article 36(5) of the ESM Treaty, such internal tax is for the benefit of the ESM.

21. Net profit on financial operations

Net profit on financial operations is detailed as follows:

(in €'000)	2018	2017
Net realised result of sales of debt securities	44,320	27,032
Net foreign exchange result	13	142
Total net result on financial operations	**44,333**	**27,174**

The net realised result of sales of debt securities reflects gains and losses realised at the date of derecognition of the respective financial assets. Up to that date, the debt securities are carried at fair value and unrealised gains and losses are recorded in the equity within the fair value reserve.

22. Staff costs

Staff costs are detailed as follows:

(in €'000)	2018	2017
Salaries[1] and allowances	23,419	22,841
Social security costs	1,088	1,251
Pension costs	7,924	7,074
Total staff costs	**32,431**	**31,166**

[1] Of which €1.7 million (2017: €1.6 million) relates to the ESM Management Board members, including €0.36 million (2017: €0.36 million) to the ESM Managing Director.

The ESM employed 179 persons on 31 December 2018 (174 on 31 December 2017).

In addition to its own employees, the ESM has expenses for employees seconded from other International Financial Institutions, as well as interim and temporary staff hired from external agencies. The related costs amount to €1.3 million for the 2018 financial year (2017: €1.2 million) and are accounted for as 'Other administrative expenses' (refer to Note 23).

23. Other administrative expenses

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

(in €'000)	2018	2017
Outsourced services (mainly IT, HR and accounting services)	9,820	8,456
Advisory services	7,948	4,815
Rental and related services	3,903	3,429
Treasury related services	1,542	1,298
Interim and secondment fees (Note 22)	1,304	1,219
Rating agencies fees	418	385
Legal services	639	1,269
IT services	3,661	2,742
Other services	4,533	5,406
Total other administrative expenses	**33,768**	**29,019**

24. Extraordinary income

The extraordinary income, totaling €242.5 million, is mainly composed of the amounts received from the Federal Republic of Germany and the French Republic, to compensate the ESM for a part of the negative interest charged on the cash held at their national central banks during 2017. These represent €128.9 million and €86.7 million respectively.

In accordance with the article 24(2) of the ESM Treaty, the ESM receives the proceeds of the financial sanctions paid by ESM Members. These are imposed under the multilateral surveillance procedure, under the excessive deficit procedure and under the macroeconomic imbalances procedures established under the Treaty on the Functioning of the European Union. The ESM also receives the financial sanctions imposed by the Court of Justice pursuant to Article 8(2) of the Treaty on Stability, Coordination and Governance (TSCG) on euro area Member States. These proceeds are recorded as extraordinary income and put aside in the reserve fund.

Accordingly, the ESM shall receive an amount of €26.8 million following a decision in May 2018 from the Council of the European Union imposing a fine on Austria.

In 2017, the extraordinary income of €18.93 million was related to an amount that the ESM received from the European Commission, following a final sentence of the Court of Justice in December 2017[5], which confirmed the Council implementing decision imposing a fine on Spain.

The financial sanctions imposed on Austria by Council implementing decision (EU) 2018/818 on 28 May 2018 and on Spain by Council implementing decision (EU) 2015/1289 on 13 July 2015 are sanctions pursuant to Article 8(1) Regulation (EU) No. 1173/2011. Such sanctions are collected by the European Commission and are assigned to the ESM.[6]

25. Off-balance commitments

The off-balance sheet commitments represent the undisbursed part of the financial assistance programme to Greece and amounts to nil after Greece officially concluded its three-year ESM financial assistance programme with a successful exit during 2018 (2017: €45.8 billion).

26. Derivatives

The ESM uses derivatives for risk management purposes only, as described in Note 2.5. Since 2015, the ESM has been entering into foreign exchange derivative transactions such as foreign exchange swaps and foreign exchange forward contracts to hedge the currency risk related to short-term non-euro denominated investments. Starting from 2017, the ESM has entered into interest rate swaps and cross-currency asset swaps for the purpose of hedging interest rate risk on euro and non-euro denominated issued debt, as well as euro and non-euro denominated investments.

All derivatives transactions are booked at notional value as off-balance sheet items at the date of the transaction.

On 31 December 2018, the derivative financial instruments had a maximum maturity up to 30 years (2017: maximum maturity up to 30 years) and were concluded with euro area central banks, international financial institutions or commercial banks.

The following table discloses the details of result on derivative contracts during the year ending on 31 December 2018.

(in €'000)	Interest receivable and similar income	Interest payable and similar charges	Net result
Interest result on interest rate swaps[(1)]	136,062	(446,803)	(310,741)
Interest result on cross-currency asset swaps	82,166	(54,745)	27,421
Up-front payments on cross-currency asset swaps	34,589	(1,525)	33,064
Spread on foreign exchange swaps	7,259	(6,229)	1,030
Spread on foreign exchange forwards	(876)	882	6
Total	**259,200**	**(508,420)**	**(249,220)**

[(1)] The net result from the IRS executed to reduce Greece's interest rate risk is passed through to Greece. (Refer to Note 3.6.1.1).

[5] ECLI:EU:C:2017:982
[6] Cf. Article 10 of Regulation 1173/2011.

The following table discloses the details of result on derivative contracts during the year ending on 31 December 2017:

(in €'000)	Interest receivable and similar income	Interest payable and similar charges	Net result
Interest result on interest rate swaps[1]	42,814	(141,797)	(98,983)
Interest result on cross-currency asset swaps	11,819	(11,114)	705
Up-front payments on cross-currency asset swaps	10,137	(36)	10,101
Spread on foreign exchange swaps	5,881	(6,548)	(667)
Spread on foreign currency forwards	688	(447)	241
Total	71,339	(159,942)	(88,603)

[1] The net result from the IRS executed to reduce Greece's interest rate risk is passed through to Greece. (Refer to Note 3.6.1.1).

The realised part included in 'Interest receivable and similar income' amounts to €188.7 million (2017: €25.1 million), while for 'Interest payable and similar charges' this represents €401.0 million (2017: €22.4 million).

27. Related - party transactions

Key management

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

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

Transactions with shareholders

The ESM granted loans to Spain, Cyprus and Greece, which are also ESM shareholders, as disclosed in more detail in Note 6. In the course of its investment activity, the ESM purchases debt securities issued by its shareholders. Such securities are reported as 'Debt securities including fixed-income securities' on the balance sheet.

In 2018, the ESM received payments from France and Germany to compensate for the negative interest charged on the cash balances held with their respective national central banks (refer to Note 24). In January 2018, €86.7 million was received from France and in August 2018 €128.9 million was received from Germany. In 2017, both Member states expressed their willingness to compensate the ESM up to the amount of negative interest charged by their national central banks with the intention to limit the negative implications on ESM's paid-in capital. The transfers were made under certain conditions and following parliament approval. Both ESM Members made similar transfers in January and February 2019, subsequent to year end (refer to Note 29).

Transactions with the European Financial Stability Facility (EFSF)

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

The EFSF was created as a temporary rescue mechanism. In accordance with its Articles of Association, the EFSF will be dissolved and liquidated when all financial assistance provided to euro area Member States and

all funding instruments issued by the EFSF have been repaid in full. As of 1 July 2013, the EFSF may no longer engage in new financing programmes or enter into new loan facility agreements.

The EFSF has asked the ESM to provide certain administrative services and other support services to facilitate the performance of its activities. To formalise this cooperation, the two organisations have entered into a service level agreement. In line with the terms of this agreement, the ESM charged the EFSF €32.6 million for the financial year 2018 (2017: €30.9 million), from which €9.8 million had not yet been paid at balance sheet date (refer to Note 10). The ESM recognised these amounts as other operating income in the profit and loss account.

Transactions with the Chairperson of the ESM Board of Governors

In October 2017, the ESM appointed Jeroen Dijsselbloem as strategic advisor to the ESM Managing Director. Mr Dijsselbloem held this position as an external service provider until the end of his term as Eurogroup President on 13 January 2018. During this period, he remained Chairperson of the ESM Board of Governors. Mr Dijsselbloem was remunerated during this time in line with the ESM's standard contracts for external service providers until the end of his term on 13 January 2018.

28. Audit fee

The total fees accrued in 2018 by the ESM to Ernst&Young, Société Anonyme are presented as follows:

(in €'000)	2018	2017
Audit fees	249	249
Audit related fees	131	205
Total Audit fees	**380**	**454**

In 2018 and 2017, the external auditors provided the ESM with audit-related services in relation with the US-dollar denominated bond issuance.

29. Events after the reporting period

On 2 January 2019 and on 4 February 2019, the ESM received €100 million from the French Republic and €135.4 million from the Federal Republic of Germany, following a political commitment to compensate the ESM for negative interest paid on the cash balances held with their respective national central banks, as explained in Note 27. These amounts will be recorded as extraordinary income in 2019 (refer to Note 2.19).

05 External auditor's report on the 2018 financial statements

To the Board of Governors of the European Stability Mechanism

Report on the audit of the financial statements

Opinion

We have audited the financial statements of European Stability Mechanism (the "Entity" or "ESM"), which comprise the balance sheet as at 31 December 2018, the profit and loss account, the statement of changes in equity and the statement of cash flows for the year then ended, and the notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements give a true and fair view of the financial position of the Entity as at 31 December 2018, and of the results of its operations and its cash flows for the year then ended 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").

Basis for opinion

We conducted our audit in accordance with EU Regulation N° 537/2014, the Law of 23 July 2016 on the audit profession (the "Law of 23 July 2016") and with International Standards on Auditing ("ISAs") as adopted for Luxembourg by the "Commission de Surveillance du Secteur Financier" ("CSSF"). Our responsibilities under those Regulation, laws and standards are further described in the « Responsibilities of the "réviseur d'entreprises agréé" for the audit of the financial statements » section of our report. We are also independent of the Entity in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants ("IESBA Code") as adopted for Luxembourg by the CSSF together with the ethical requirements that are relevant to our audit of the financial statements, and have fulfilled our other ethical responsibilities under those ethical requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key audit matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of the audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Impairment of loans and advances

As at 31 December 2018, the loans and advances to euro area Member States amounted to EUR 89.9 billion and related to financial assistance granted to Spain, Cyprus and Greece in line with ESM's mission to provide financial assistance to euro area countries experiencing or threatened by severe financing problems. These loans were granted to recapitalise banks in Spain, and as part of a macroeconomic adjustment programme in the case of Cyprus and Greece. For the

year ending 31 December 2018, no impairment has been recorded by ESM on these outstanding loans.

We considered this as a key audit matter as ESM applies complex judgments with respect to the estimation of the amount and timing of the future cash flows when determining the necessity to record or not an impairment loss on the loans granted.

To assess the required impairment allowance and in accordance with article 13(6) of 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 - ESM assesses individually each loan and advance granted to the beneficiary ESM Members on a regular basis through the analysis of the main following indicators of the beneficiary country:

- the liquidity situation of the sovereign;
- the market access;
- the long-term sustainability of public debt;
- the banking prospects, whenever relevant to assess repayment flows;
- the review of the medium-term economic and financial outlook;
- the identification of default events.

The determination of the necessity to record an impairment will be based on the identification of impairment events and judgments to estimate the impairment against specific loans and advances.

Refer to the notes 2 and 6 to the financial statements.

How the matter was addressed in our audit

We assessed the design and implementation, and tested the operating effectiveness of the key controls over ESM's processes for establishing and monitoring specific impairment estimation. This includes:

- the testing of the entity level controls over the process, including the review and approval of the assumptions made by the Management;
- the testing of the quarterly Early Warning System reports issued per country and checking if impairment recommendations have been adequately applied;
- the testing of assumptions underlying judgments made by the Management when an impairment event occurs on expected cash flows and estimated recovery from any underlying collateral;
- the testing of a sample of loans to form our own assessment as to whether impairment events have occurred and to assess whether impairment was identified and recorded in a timely manner, where required;
- the reading and assessment of the related contents of the major internal committees minutes;
- Checking that reimbursements [and waivers granted] are made in accordance with the terms and conditions agreed;
- Reconciling amounts disbursed with the loan agreements and ensuring that loans granted to ESM Members are within the limit of commitments approved by the governing bodies of ESM.

Responsibilities of the Board of Directors and of those charged with governance for the financial statements

The Board of Directors is responsible for the preparation and fair presentation of the 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.

In preparing the financial statements, the Board of Directors is responsible for assessing the entity's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the Board of Directors either intends to liquidate the Entity or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Entity's financial reporting process.

Responsibilities of the "réviseur d'entreprises agréé" for the audit of the financial statements

The objectives of our audit are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue a report of the "réviseur d'entreprises agréé" that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with EU Regulation N° 537/2014, the Law of 23 July 2016 and with the ISAs as adopted for Luxembourg by the CSSF will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with EU Regulation N° 537/2014, the Law of 23 July 2016 and with ISAs as adopted for Luxembourg by the CSSF, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit 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.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the Board of Directors.
- Conclude on the appropriateness of Board of Directors' use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Entity's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our report of the "réviseur d'entreprises agréé" to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our report of the "réviseur d'entreprises agréé". However, future events or conditions may cause the Entity to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our report unless law or regulation precludes public disclosure about the matter.

Report on other legal and regulatory requirements

We have been appointed as "réviseur d'entreprises agréé" by the Board of Governors on 15 June 2017 and the duration of our uninterrupted engagement, including previous renewals and reappointments, is 2 years.

We confirm that the audit opinion is consistent with the additional report to the audit committee or equivalent.

We confirm that the prohibited non-audit services referred to in EU Regulation No 537/2014 were not provided and that we remained independent of the Entity in conducting the audit.

Ernst & Young
Société anonyme
Cabinet de révision agréé

Bernard Lhoest | Papa Saliou Diop
Luxembourg, March 26, 2019

06 Report of the Board of Auditors on the 2018 financial statements

Luxembourg, 26 March 2019

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.[1]

This Board of Auditors' report in respect of 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 2018.

The Board of Auditors notes that based on its own work and considering the work of the external auditor, to the best of its judgment, no 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 2018.

On behalf of the Board of Auditors

Kevin Cardiff
Chairperson

[1] 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 their results. Information on the audit work of the Board of Auditors, its audit findings, conclusions and recommendations for the year ended 31 December 2018 will be included in the annual report, to be prepared in accordance with Article 24 (6) of the ESM By-Laws and submitted to the Board of Governors.

Acronyms and abbreviations

ALM Asset and Liability Management

BoA Board of Auditors

BoD Board of Directors

BoG Board of Governors

CCB Cyprus Cooperative Bank

CDS Credit default swap

CPI Consumer price inflation

ECB European Central Bank

EFSF European Financial Stability Facility

EMU Economic and Monetary Union

ESM European Stability Mechanism

GDP Gross domestic product

GDPR General Data Protection Regulation

GLF Greek Loan Facility

HCAP Hellenic Corporation of Assets and Participations

HFSF Hellenic Financial Stability Fund

IFI International financial institution

IMF International Monetary Fund

ISDA International Swaps and Derivatives Association

NPL Non-performing loan

PSPP Public Sector Purchase Programme

RCSA Risk and Control Self-Assessment

SRB Single Resolution Board

SRF Single Resolution Fund

SSA Sovereign, Supranational and Agency

TRSA Top Risk Self-Assessment

EURO AREA

COUNTRY CODE	COUNTRY NAME
BE	Belgium
DE	Germany
EE	Estonia
IE	Ireland
EL	Greece
ES	Spain
FR	France
IT	Italy
CY	Cyprus
LV	Latvia
LT	Lithuania
LU	Luxembourg
MT	Malta
NL	Netherlands
AT	Austria
PT	Portugal
SI	Slovenia
SK	Slovakia
FI	Finland

NON-EURO AREA

COUNTRY CODE	COUNTRY NAME
US	United States

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