

Term Sheet on the ESM

The European Council has agreed on the need for euro-area Member States to establish a permanent stability mechanism: the European Stability Mechanism (ESM). The ESM will be activated by mutual agreement¹, if indispensable to safeguarding the financial stability of the euro area as a whole. The ESM will assume the role of the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM) in providing external financial assistance to euro-area Member States after June 2013.

Access to ESM financial assistance will be provided on the basis of strict policy conditionality under a macro-economic adjustment programme and a rigorous analysis of public-debt sustainability, which will be conducted by the Commission together with the IMF and in liaison with the ECB. The beneficiary Member State will be required to put in place an appropriate form of private-sector involvement, according to the specific circumstances and in a manner fully consistent with IMF practices.

The ESM will have an effective lending capacity of € 500 billion². The adequacy of the lending capacity will be reviewed on a regular basis and at least every five years. The ESM will seek to supplement its lending capacity through the participation of the IMF in financial assistance operations, while non-euro area Member States may also participate on an ad hoc basis.

The remainder of this term sheet sets out the key structural features of the ESM:

Institutional form

The ESM will be established by a treaty among the euro-area Member States as an intergovernmental organisation under public international law and will be located in Luxembourg. The statute of the ESM will be set out in an annex to the treaty.

Function and funding strategy

The function of the ESM will be to mobilise funding and provide financial assistance, under strict conditionality, to the benefit of euro-area Member States,

¹ A decision taken by mutual agreement is a decision taken by unanimity of the Member States participating to the vote, i.e. abstentions do not prevent the decision from being adopted.

² During the transition from EFSF to ESM, the combined lending capacity will not exceed this amount.

which are experiencing or are threatened by severe financing problems, in order to safeguard the financial stability of the euro area as a whole.

The Member States of the euro area will give to the ESM the financial sanctions received under the Stability and Growth Pact and the Macroeconomic Imbalances procedures. Such sanctions will form part of the paid-in capital.

The ESM will use an appropriate funding strategy so as to ensure access to broad funding sources and enable it to extend financial assistance packages to Member States under all market conditions. Any associated risk will be contained through adequate asset and liability management.

Governance

The ESM will have a Board of Governors consisting of the Ministers of Finance of the euro-area Member States (as voting members), with the European Commissioner for Economic and Monetary Affairs and the President of the ECB as observers. The Board of Governors will elect a Chairperson from among its voting members.

The Board of Governors will be the highest decision-making body of the ESM and will take the following major decisions by mutual agreement:

- the granting of financial assistance;
- the terms and conditions of financial assistance;
- the lending capacity of the ESM;
- changes to the menu of instruments.

All other decisions by the Board of Governors will be taken by qualified majority, unless stated otherwise.

The ESM will have a Board of Directors, which will carry out specific tasks as delegated by the Board of Governors. Each euro-area Member state will appoint one Director and one alternate Director. In addition, the Commission and the ECB will each nominate an observer and an alternate to the Board of Directors. All decisions by the Board of Directors will be taken by qualified majority, unless otherwise stated.

Voting weights within the Board of Governors and the Board of Directors will be proportional to the Member States' respective subscriptions to the capital of the ESM. A qualified majority is defined as 80 percent of the votes.

The Board of Governors will appoint a Managing Director responsible for the day-to-day management of the ESM. The Managing Director will chair the Board of Directors.

Capital structure

The ESM will aim to obtain and maintain the highest credit rating from the major credit rating agencies.

The ESM will have a total subscribed capital of € 700 billion. Of this amount, € 80 billion will be in the form of paid-in capital provided by the euro-area Member States, of which € 40 billion will be available from July 2013 with the remaining share being phased in over the three following years. In addition, the ESM will also dispose of a combination of committed callable capital and of guarantees from euro area Member States to a total amount of € 620 billion.

The contribution key of each Member State in the total subscribed capital of the ESM will be based on the paid-in capital key of the ECB as annexed. By ratifying the Treaty establishing the ESM, Member States legally commit to provide their contribution to the total subscribed capital.

The Board of Governors will decide by mutual agreement when adapting the amount of total subscribed capital or when calling capital, except in the specific cases described below. First, the Board of Directors can decide, by simple majority, to restore -by calling in capital- the level of paid-in capital in the event that the amount of paid-in capital is reduced by the absorption of losses³. Second, an on-demand guarantee procedure will be put in place that allows calling in capital automatically from the shareholders of the ESM if needed to avoid a payment shortfall to the creditors of the ESM. The liability of each shareholder will in all circumstances be limited to its share in the subscribed capital.

Any contribution to subscribed capital by a Member State⁴ joining the ESM after July 2013 will be made according to the same terms applied for the original contributions. The practical implications for the overall amount of subscribed capital and the distribution of capital among the Member States will be decided by the Board of Governors by mutual agreement.

As long as the ESM has not been activated and provided that the effective lending capacity is not less than 500 billion, the proceeds from the investment of the ESM paid-in capital will be returned to the Member States, after deductions for operational costs. Following the first activation of the ESM, the proceeds from the investment of ESM capital and financial assistance activity will be retained within the ESM. However, in the event that paid-in capital exceeds the

³ The vote of the Member State whose default is at the origin of the loss to be covered is suspended for this decision.

⁴ As a consequence of joining the euro area, a Member State shall become a member of the ESM with full rights and obligations.

level required to maintain the lending capacity of the ESM, the Board of Directors can decide, by simple majority to distribute a dividend to the euro-area Member States based on the contribution key.

Instruments

The ESM will provide financial assistance subject to strict conditionality under a macro-economic adjustment programme, commensurate with the severity of the imbalances of the Member State. It will be provided through loans.

However, it may intervene, as an exception, in debt primary markets on the basis of a macro-economic adjustment programme with strict conditionality and if agreed by the Board of Governors by mutual agreement.

- ESM stability support (ESS)

The ESM can grant short-term or medium term stability support to a euro-area Member State, which is experiencing severe financing problems. Access to an ESS will imply a macroeconomic adjustment programme with adequate policy conditionality commensurate with the severity of the underlying imbalances in the beneficiary Member State. The length of the programme and maturity of the loans will depend on the nature of the imbalances and the prospects of the beneficiary Member States regaining access to financial markets within the time that ESM resources are available.

- Primary market support facility

The ESM can purchase the bonds of a Member State, which is experiencing severe financing problems, on the primary market, with the objective of maximizing the cost efficiency of the support. Conditions and modalities under which bond purchasing would be conducted will be specified in the Decision on the terms and conditions of financial assistance.

The Board of Governors may review the instruments at the ESM's disposal and may decide to make changes to the menu of instruments.

IMF involvement

The ESM will cooperate very closely with the IMF in providing financial assistance⁵. In all circumstances, active participation of the IMF will be sought, both on the technical and the financial level. The debt sustainability analysis will be jointly conducted by the Commission and the IMF, in liaison with the ECB. The policy conditions attached to a joint ESM/IMF assistance will be negotiated jointly by the Commission and the IMF, in liaison with the ECB.

Activation of financial assistance, programme monitoring and follow-up

Financial assistance from the ESM will in all cases be activated on a request from a Member State to the other Members States of the euro area. The Eurogroup will inform the Council that a request for activation of support has been made. On receipt of such a request, the Board of Governors will ask the Commission to assess, in liaison with the ECB, the existence of a risk to the financial stability of the euro area as a whole and to undertake a rigorous analysis of the sustainability of the public debt of the Member State concerned, together with the IMF and in liaison with the ECB. The subsequent steps in the activation of ESM financial assistance will be as follows:

- If an ESS is requested, the Commission, together with the IMF and in liaison with the ECB, will assess the actual financing needs of the beneficiary Member State and the nature of the required private sector involvement, which should be consistent with IMF practices.
- On the basis of this assessment, the Board of Governors will mandate the Commission to negotiate, together with the IMF and in liaison with the ECB, a macro-economic adjustment programme with the Member State concerned, detailed in a MoU.
- The Commission will propose to the Council a decision endorsing the macro-economic adjustment programme. The Board of Governors will decide on the granting of financial assistance and the terms and conditions under which assistance is provided. When the programme has been adopted by the Council, the Commission will sign the MoU on behalf of the euro area Member States subject to prior mutual agreement by the Board of Governors. The Board of Directors will then approve the financial assistance agreement which would contain the technical aspects of the financial assistance to be provided.

⁵ It is however understood that any IMF involvement will be consistent with its mandate under the Articles of Agreement and by applicable decision and policies of the IMF Board.

- The Commission, together with the IMF and in liaison with the ECB, will be responsible for monitoring compliance with the policy conditionality required by a macroeconomic adjustment programme. It will report to the Council and to the Board of Directors. On the basis of this report, the Board of Directors will decide by mutual agreement on the disbursement of the new tranches of the loan.
- After discussion in the Board of Governors, the Council can decide, on a proposal by the Commission, to implement post-programme surveillance, which can be maintained for as long as a specified amount of the financial assistance has not been repaid.

Consistency with the EU multilateral surveillance framework

Approval by the EU Member States will be sought to allow the euro-area Member States to task the Commission, together with the IMF and in liaison with the ECB, the analysis of the debt sustainability of the Member State requesting financial support, the preparation of the adjustment programme accompanying the financial assistance, as well as with the monitoring of its implementation.

While the Board of Governors has the autonomy to decide on the existence and modalities of financial assistance under an intergovernmental framework, the policy conditionality established under an enhanced surveillance or a macroeconomic adjustment programme should be consistent with the EU surveillance framework and must guarantee the respect of EU procedures. To this end, the Commission intends to propose a Regulation clarifying the necessary procedural steps under Article 136 of the Treaty in order to enshrine the policy conditionality in Council decisions and ensure consistency with the EU multilateral surveillance framework. The Council and the Commission will inform the European Parliament on a regular basis about the establishment and the operations of the ESM.

Pricing

The Board of Governors will decide on the pricing structure for financial assistance to a beneficiary Member State.

The ESM will be able to lend at a fixed or variable rate. The pricing of the ESM will be in line with IMF pricing principles and, while remaining above the funding costs of ESM, will include an adequate mark up for risks.

The following pricing structure will apply to ESM loans:

- 1) ESM funding cost

2) A charge of 200 bps applied on the entire loans

3) A surcharge of 100 bps for loan amounts outstanding after 3 years

For fixed rate loans with maturities above 3 years, the margin will be a weighted average of the charge of 200 bps for the first 3 years and 200 bps plus 100 bps for the following years.

The pricing structure will be defined in the pricing policy of the ESM, which will be reviewed periodically.

Private sector involvement

1. Modalities for involving the private sector

An adequate and proportionate form of private-sector involvement will be expected in all cases where financial assistance is received by the beneficiary State. The nature and extent of this involvement will be determined on a case-by-case basis and will depend on the outcome of a debt sustainability analysis, in line with IMF practice⁶, and on potential implications for euro-area financial stability.

(a) If, on the basis of a sustainability analysis, it is concluded that a macro-economic adjustment programme can realistically restore the public debt to a sustainable path, the beneficiary Member State will take initiatives aimed at encouraging the main private investors to maintain their exposures (e.g. a "Vienna Initiative" approach). The Commission, the IMF, the ECB and the EBA will be closely involved in monitoring the implementation of such initiatives.

(b) If, on the basis of a sustainability analysis, it is concluded that a macro-economic programme cannot realistically restore the public debt to a sustainable path, the beneficiary Member State will be required to engage in active negotiations in good faith with its creditors to secure their direct involvement in restoring debt sustainability. The granting of the financial assistance will be contingent on the Member State having a credible plan and demonstrating sufficient commitment to ensure adequate and proportionate private sector involvement. Progress in the implementation of the plan will be monitored under the programme and will be taken into account in the decision on disbursements.

⁶ In line with the IMF, debt is considered sustainable when a borrower is expected to be able to continue servicing its debts without an unrealistically large correction to its income and expenditure. This judgement determines the availability and the appropriate scale of financing.

In negotiating with creditors, the beneficiary Member State will adhere to the following principles:

- *Proportionality*: the Member State will seek solutions proportionate to its debt sustainability problem.
- *Transparency*: the Member State concerned will engage in an open dialogue with creditors and share relevant information with them on a timely basis.
- *Fairness*: the Member State will consult creditors on the design of any rescheduling or restructuring of public debt with a view to reaching negotiated solutions. Measures reducing the net present value of the debt will be considered only when other options are unlikely to deliver the expected results.
- *Cross-border co-ordination*: the risk of contagion and potential spill over effects on other Member States and third countries will be duly taken into account in the design of measures to involve the private sector. The measures taken will be accompanied with a proper communication by the Member State concerned aimed at preserving the financial stability of the Euro Area as a whole.

2. Collective Action Clauses

Collective Action Clauses (CACs) will be included in all new euro area government securities, with maturity above one year, from July 2013. The objective of such CACs will be to facilitate agreement between the sovereign and its private-sector creditors in the context of private sector involvement. The inclusion of CACs in a bond will not imply a higher probability of default or of debt restructuring relating to that bond. Accordingly, the creditor status of sovereign debt will not be affected by the inclusion of CACs.

The main features of the CACs will be consistent with those commonly used in the US and the UK markets since the G10 report on CACs. CACs will be introduced in a way which preserves a level playing field among euro area Member States. This implies the use of **identical and standardized clauses** for all euro area Member States, harmonized in the terms and conditions of securities issued by the Members States. Their basis will be **consistent with the CACs that are common in New York and English law**.

CACs will include an **aggregation clause**, enabling a super majority of bondholders across multiple bond issues subject to such a clause and subject to

the law of a single jurisdiction to include a majority action clause where the needed majority of creditors for the restructuring would not be attained within a single bond issue. **Appropriate representation** will be put in place. Most important issues – the reserve matters – (e.g. key payment terms, conversion or exchange of bonds) will be decided with a larger **majority** than non-reserve matters. Appropriate **quorum** requirements will apply. Changes agreed by the relevant majorities are binding on all bondholders.

An appropriate **disenfranchisement** clause will apply to ensure a proper voting process. Appropriate clauses to prevent disruptive legal action will be considered.

CACs will be introduced in a standardized manner, which ensures that their legal impact is identical in all euro-area jurisdictions and so preserves a level playing field among euro-area Member States. The euro area Member States will adopt the necessary measures to give effect to the CACs.

Euro area Member States will be allowed to continue to “tap” outstanding debt without CACs under pre-determined conditions after June 2013 in order to preserve the necessary liquidity of old bonds and to give sufficient time to euro area Member States to create, in an orderly fashion, new bonds on all benchmark maturities. The detailed legal arrangements for including CACs in euro-area government securities will be decided on the basis of work to be undertaken by the EFC Sub-Committee on EU Sovereign Debt Markets, following appropriate consultation with market participants and other stakeholders, and be finalised by the end of 2011.

3. Preferred Creditor Status of the ESM

Like the IMF, the ESM will provide financial assistance to a Member State when its regular access to market financing is impaired. Reflecting this, Heads of State or Government have stated that the ESM will enjoy preferred creditor status in a similar fashion to the IMF, while accepting preferred creditor status of IMF over ESM.

This shall be effective as of 1 July 2013 without prejudice to the terms and conditions of any other agreement provided under the EFSF and the Greek facility.

Transitional arrangements between EFSF and ESM

As originally foreseen, the EFSF will remain in place after June 2013 so as to administer the outstanding bonds. It will remain operational until it has received full payment of the financing granted to the Member States and has repaid its liabilities under the financial instruments issued and any obligations to reimburse guarantors. Undisbursed and unfunded portions of existing loan facilities should be transferred to the ESM (e.g. payment and financing of instalments that would become due only after the entry into force of ESM). The consolidated EFSF and ESM lending shall not exceed € 500 bn.

To ensure a smooth transition from the EFSF to the ESM, the CEO of the EFSF will be tasked with the practical preparation of the establishment of the ESM. He will regularly report on the progress made to the Eurogroup Working Group.

Participation of the non euro area Member States

Non euro area Member States can participate on an *ad hoc* basis alongside the ESM in financial assistance operations for euro area Member States. If non-euro area Member States participate in such operations, they will be represented in the relevant meetings of the ESM boards that will decide on the granting and the monitoring of the assistance. They will have access to all relevant information in a timely manner and be appropriately consulted. The euro area Member States will support equivalent creditor status of the ESM and that of other Member States lending bilaterally alongside the ESM.

Dispute settlement

If a dispute arises between a euro area Member State and the ESM in connection with the interpretation and application of the treaty establishing the ESM, the Board of Governors will decide on this dispute. If the Member State contests this decision, such dispute shall be submitted to the European Court of Justice in accordance with Art. 273 TFEU.

With regard to the relationship between the ESM and third parties, the applicable governing law and jurisdiction will be dealt with by the legal and contractual documentation which will then be put in place between the ESM and those third parties.

Annex: ESM contribution key based on the ECB key

ESM contribution key

Country	ISO	ESM key
Austria	AT	2.783
Belgium	BE	3.477
Cyprus	CY	0.196
Estonia	EE	0.186
Finland	FI	1.797
France	FR	20.386
Germany	DE	27.146
Greece	EL	2.817
Ireland	IE	1.592
Italy	IT	17.914
Luxembourg	LU	0.250
Malta	MT	0.073
Netherlands	NL	5.717
Portugal	PT	2.509
Slovakia	SK	0.824
Slovenia	SI	0.428
Spain	ES	11.904
Total	EA17	100.0

Notes: The ESM key is based on the ECB capital contribution key.

Member States with a GDP per capita of less than 75% of the EU average will benefit from a temporary correction for a period of 12 years after their entry in the euro area.

This temporary correction will be three quarters of the difference between GNI and ECB capital shares (effectively comprising of 75% of GNI share and 25% of ECB capital share) as follows: $ESM\ share = ECB\ key\ share - 0,75*(ECB\ key\ share - GNI\ share)$

The downwards compensation on those countries is redistributed among all the other countries according to their ECB key share.

GNI and GDP per capita in 2010.

Sources: ECB, Ameco and DG ECFIN calculations.