

2012

Annual Report

European Stability Mechanism



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One can see **good progress in moving out of the crisis** even though the situation in the real economy of countries in the periphery remains very difficult

..... Klaus REGLING
..... Managing Director
..... European Stability Mechanism (ESM)

..... Jean-Claude JUNCKER
..... Prime Minister of Luxembourg
..... Former President of EUROGROUP

Introduction and Highlights

1. Message by the ESM's Managing Director

On 8 October 2012, the European Stability Mechanism (ESM) was officially inaugurated. It was the result of a decision by 17 euro area Member States to create a permanent crisis resolution fund to provide financial assistance under strict conditionality, appropriate to the financial assistance instrument chosen, to euro area countries in temporary need of assistance. In doing so, they filled an important institutional gap that would have left the euro area vulnerable, as evidenced in the beginning of the crisis.

The ESM operates in line with the same policies and principles as the European Financial Stability Facility (EFSF), established by the euro area as a temporary response in the wake of the 2010 crisis. Thanks to the ESM and interventions on the part of the European Central Bank, credible backstops for the euro area are now in place. Together with courageous reforms at national level and stringent economic policy coordination at European level, one can see good progress in moving out of the crisis even though the situation in the real economy remains very difficult.

While EFSF bonds are backed by guarantees from the euro area Member States, the ESM has a capital of EUR 700 billion, of which EUR 80 billion amounts to paid-in capital by its Member States. This will make the ESM the International Financial Institution with the highest paid-in capital worldwide, with a very robust capital structure. According to the ESM treaty, paid-in capital must be transferred by the euro area countries in five tranches of EUR 16 billion. Three tranches have been paid, bringing the level to EUR 48 billion at present. This process should be completed by middle of 2014.

The ESM has a lending capacity of EUR 500 billion, but as the EFSF continues to manage the financial assistance programmes in Ireland, Portugal and Greece with a volume of almost EUR 200 billion, the effective combined lending capacity is in fact EUR 700 billion. The EFSF is henceforth unable to enter any new programmes. As a consequence, the ESM will be the only mechanism able to respond to new requests for financial assistance if they are made by euro area Member States.

Evidence in Ireland, Portugal and Greece shows that the strategy of providing loans with strong conditions attached is working. The macroeconomic divergences within the monetary union are declining as these countries gain in competitiveness by decreasing their unit labour costs and balancing their current accounts. The fiscal deficits in the programme countries are declining and the aggregate fiscal situation of the euro area as a whole is now in a much better position than in the US, UK and Japan. The markets have rewarded this development with falling government bond yields for Ireland and Portugal and by allowing them to progressively regain market access.

This initial Annual Report is atypical as its financial statement only covers the period from 8 October to 31 December 2012. The first financial assistance provided by the ESM was to recapitalise the Spanish banking sector in December 2012. In the summer of the same year, up to EUR 100 billion of assistance was committed for that purpose. Out of that envelope, the ESM has transferred EUR 41.3 billion to the Spanish state. The government in Madrid used the funds to recapitalise eight banks and SAREB, the asset management company. In return, Spain has agreed to strong sector-specific conditionality. ►

The ESM's first fully fledged financial assistance under a macroeconomic adjustment programme was approved in early May 2013 for Cyprus. Until the first quarter of 2016, the ESM will disburse approximately EUR 9 billion to the government in Nicosia. The condition for these loans is that the country extensively reforms its banking sector, consolidates its budget and carries out structural reforms to regain competitiveness and stimulate growth. In implementing the Cyprus financial assistance programme, the ESM draws on experience gained by the EFSF in programmes with Ireland, Portugal and Greece.

For the time being, the bulk of the programme funding is provided by the EFSF. This makes sense as the programmes with the largest volumes are still run by the EFSF. The ESM is slowly taking over. On 8 January, it successfully launched its bill programme to replace the EFSF bill programme. The ESM raised over EUR 11.3 billion in 3-month and 6-month bills in the first quarter 2013 via regular pre-announced auctions. We also expect the ESM to become active on the long-term bond market in the second half of 2013. In the first quarter of 2012, the EFSF raised EUR 16.5 billion. It has become a regular and well-established issuer in the supranational segment since its establishment in 2010. We fully expect the ESM to follow suit.



Klaus REGLING

Managing Director
European Stability Mechanism (ESM)

The Management Board Members



Christophe Frankel
Deputy Managing Director
CFO



David Vegara
Deputy Managing Director
Banking



Kalin Anev
Secretary General



Ralf Jansen
General Counsel



Rolf Strauch
Economics and Policy
Strategy



With **EUR 80 billion paid-in capital**, the ESM will be the International Financial Institution with the highest paid-in capital worldwide

2. Letter of transmittal to the Board of Governors

European Stability Mechanism



20 June 2013

Dear Mr. Chairman:

I have the honour to present to the Board of Governors the Annual Report for the financial year 2012, in accordance with Article 23 of the By-laws of the European Stability Mechanism (hereafter "By-laws").

The audited financial statements for the period from 8 October 2012 (date of inauguration of the ESM) to 31 December 2012 as drawn up by the Board of Directors on 21 March 2013 under Article 21 of the By-laws are presented in Chapter III. The external audit was overseen by the Board of Auditors as required under Article 24 (4) of the By-laws.

Klaus Regling
Managing Director



Evidence in Ireland,
Portugal and
Greece shows that
the strategy of
providing loans
with **strong
conditions
attached** is
working

3. ESM mandate

The ESM is a permanent crisis resolution mechanism established by the euro area Member States as an inter-governmental organisation under public international law. Its purpose is to ensure the financial stability of the euro area as a whole and of its Member States by providing stability support via a number of financial assistance instruments, which are intended for ESM Members experiencing, or threatened by, severe financing problems. For this purpose, the ESM is entitled to raise funds by issuing capital market instruments and engaging in money market transactions.

Following the ratification of the ESM Treaty by euro area Member States, the ESM was inaugurated in Luxembourg on 8 October 2012, during the first meeting of the ESM Board of Governors comprising euro area finance ministers.

The ESM has a total subscribed capital of EUR 700 billion. Of this amount, EUR 80 billion is paid-in capital provided by the euro area Member States in five instalments of EUR 16 billion each. The first two capital instalments were paid in 2012. The third instalment was paid in April 2013 while the two remaining instalments are expected to be transferred by the Member States in October 2013 and April 2014, respectively.

The remaining subscribed capital, amounting to EUR 620 billion, is available in the form of committed callable capital from euro area Member States.

The paid-in capital is invested in high quality liquid assets in accordance with the ESM investment guidelines. It serves as loss-absorbing capital only. Thus the paid-in capital will not be used to purchase sovereign bonds under an ESM primary or secondary market intervention, nor to provide loans to Members within a macroeconomic adjustment programme, but it can be used to purchase top-rated and liquid sovereign bonds for investment purposes.

In order to effectively perform its purpose of providing stability support to Member States, the ESM raises funds by issuing financial instruments or entering into financial and other agreements with ESM Members, financial institutions or other third parties. The ESM seeks to adopt a funding strategy that ensures access to broad funding sources and enables it to extend financial assistance packages to its Members under all market conditions. In particular, the ESM pursues a diversified funding strategy, i.e. funds raised are pooled and not attributed to a particular country. The ESM may issue bills and bonds with maturities ranging up to 30 years. Issues may be made via syndications, auctions, private placements and taps of existing lines.

All financial assistance to Member States is linked to appropriate conditionality specified in a Memorandum of Understanding (MoU) to be concluded by the European Commission, ECB, IMF (where applicable) and the relevant beneficiary Member States, and is provided only if the financial stability of the euro area as a whole or of its Member States is at risk.

The ESM stability instruments:

- loans to ESM Members experiencing or threatened by severe financing problems
- financial assistance for the purpose of recapitalisations of financial institutions through loans to ESM Members, including in non-programme countries
- precautionary financial assistance in the form of a credit line
- bond purchases of an ESM Member in the primary debt market
- bond purchases of an ESM Member in the secondary debt market

European Stability Mechanism



European Financial Stability Facility



The ESM **assumes the tasks** previously fulfilled by the EFSF and the EFSM in providing, where needed, financial assistance to euro area Member States

4. EFSF/ESM Transition

The European Council agreed on 17 December 2010 on the need for euro area Member States to establish a permanent stability mechanism. Klaus Regling, the CEO of EFSF was charged with the practical preparations for establishing the ESM. On 2 February 2012 the Treaty Establishing the European Stability Mechanism was signed. The ESM Treaty entered into force on 27 September 2012 and the ESM was officially inaugurated on 8 October 2012. Klaus Regling was appointed Managing Director of the ESM the same day and remains CEO of the EFSF.

The ESM assumes the tasks previously fulfilled by the EFSF and the EFSM in providing, where needed, financial assistance to euro area Member States. However, the ongoing macro-economic adjustment programmes for Ireland, Portugal and Greece will continue to be financed by the EFSF. The combined lending capacity of the ESM with its EUR 500bn and the EFSF is EUR 700bn.

As the creation of the ESM should not lead to double structures, the goal was from the start to temporarily have two institutions with the same staff. As a consequence all EFSF employment contracts were transferred to the ESM. Pursuant to a service level agreement between the two institutions staff of the ESM will continue to perform activities for the EFSF.

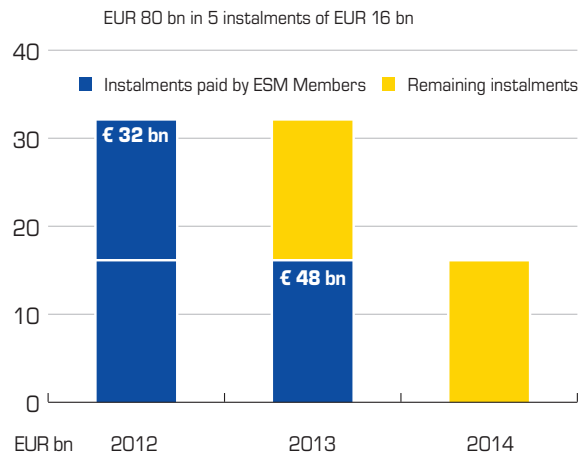
Since the ESM was conceived as an autonomous international organisation, temporary EFSF arrangements such as the outsourcing of core activities to third parties were no longer an option. Therefore the ESM decided to perform all funding activities so far performed by Bundesrepublik Deutschland – Finanzagentur GmbH and to take over most institutional services from the European Investment Bank.

The Kingdom of Spain requested financial assistance from the EFSF under a bank recapitalization facility in June 2012. As it was already clear that the ESM would be created the Heads of State or Government of the euro area stated only a few days later that this financial assistance would be transferred to the ESM once it became available. The financial assistance programme for Spain became the first ESM operation when disbursements started in December 2012.

The ESM started a bill programme. In order to add clarity EFSF stopped issuing short term papers and since January 2013 the ESM issues bills according to a pre-established calendar communicated to the markets.

5. Highlights

Table 1: ESM paid-in capital



Total paid in capital by ESM member in 2012.

As of end of April 2013, a new instalment of EUR 16 billion was paid, adding up to a total paid in capital of EUR 48 billion

Table 2: Lending

ESM	Countries	Programme funded by ESM		Already disbursed by ESM*
	Spain	100.0	(2012)	39.5
			(Q1/13)	1.9
	Cyprus*	9.0		0.0
	Total	109		41.3

* As of 31 December 2012 the loans outstanding to Spain amount to EUR 39.5 bn. An additional disbursement was made during Q1 2013 of EUR 1.9 bn. After the approval at the end of April 2013 of the Financial Assistance Facility Agreement for Cyprus, the first tranche of EUR 3 billion is expected to be disbursed in the first semester of this year.

EUR 39.5 billion

Sum raised and disbursed by the ESM in 2012

Table 3: Funding

ESM	€ billion	2012	2013	2014	Total 2011-2014
	Total Lending Programme		39,5	6,9	2,1
(1) of which Cash Transactions			3,4	1,6	5,0
(2) LT Funding redemptions			6,5	0,0	6,5
Total LT Funding need (1+2)		0,0	9,9	25,4	35,3
LT Funding Program			9,0	15,1	24,1
"ST Funding Outstanding (End of Period)"		9,0	16,0	13,5	
"Outstanding debt (as of end of the year)"		39,5	59,0	53,0	

As of December 31st, 2012 the debt issuance amounted to EUR 39.5 bn. 2013 and 2014 figures are tentative based on the future disbursements to beneficiary ESM Members.



The most important decisions taken by the Board of Governors of the ESM require mutual agreement.

Policies and Activities

1. ESM Governance

1.1 ESM Treaty

The 17 euro area Member States jointly set up the ESM as an international financial institution by way of an international treaty signed on 2 February 2012 in Brussels. The Treaty establishing the European Stability Mechanism entered into force on 27 September 2012 and the inaugural Board of Governors meeting was held on 8 October 2012. The contracting parties are the euro area Member States (also referred to as ESM Members). As a consequence of joining the euro area, a Member State of the European Union should become an ESM Member with full rights and obligations, in line with those of the Contracting Parties.

1.2 ESM shareholders

The ESM's shareholders are the 17 euro area Member States. The contribution key for subscribing to ESM authorised capital stock is based on the ECB capital contribution key (as stated in article 42 of the ESM Treaty), which reflects the respective country's share in the total population and GDP of the EU.

The authorised capital stock is EUR 700 billion, which is divided in accordance with the contribution key. The authorised capital stock is divided into paid-in shares and callable shares. The paid-in capital amounts to EUR 80 billion.

Table 4

ESM Member	ESM Key (%)	N° of Shares	Capital subscription (EUR)
Kingdom of Belgium	3.4771	243 397	24 339 700 000
Federal Republic of Germany	27.1464	1 900 248	190 024 800 000
Republic of Estonia	0.1860	13 020	1 302 000 000
Ireland	1.5922	111 454	11 145 400 000
Hellenic Republic	2.8167	197 169	19 716 900 000
Kingdom of Spain	11.9037	833 259	83 325 900 000
French Republic	20.3859	1 427 013	142 701 300 000
Italian Republic	17.9137	1 253 959	125 395 900 000
Republic of Cyprus	0.1962	13 734	1 373 400 000
Grand Duchy of Luxembourg	0.2504	17 528	1 752 800 000
Malta	0.0731	5 117	511 700 000
Kingdom of the Netherlands	5.7170	400 190	40 019 000 000
Republic of Austria	2.7834	194 838	19 483 800 000
Portuguese Republic	2.5092	175 644	17 564 400 000
Republic of Slovenia	0.4276	29 932	2 993 200 000
Slovak Republic	0.8240	57 680	5 768 000 000
Republic of Finland	1.7974	125 818	12 581 800 000
Total	100.0000	7 000 000	700 000 000 000



1.3. Voting rights

The voting rights of each ESM Member, as exercised by its appointees in the governing bodies of the ESM, are equal to the number of shares held.

ESM Members irrevocably and unconditionally undertake to provide their contribution to the authorised capital stock and are bound to meet all capital calls on a timely basis. If any ESM Member were to fail to pay any part of the amounts due in respect of its obligations, the respective ESM Member would be unable to exercise any of its voting rights for so long as such failure persisted.

1.4. Board of Governors

Each ESM Member appoints a Governor and an alternate Governor. The Governor is the member of the government of the ESM Member who has responsibility for finance. The Member of the European Commission in charge of economic and monetary affairs and the President of the ECB may participate in the meetings of the Board of Governors as observers.

The most important decisions taken by the Board of Governors require mutual agreement (100% of voting rights cast). These include decisions to provide stability support to an ESM Member, the choice of instruments, inter alia conditions and terms of such support, changing the authorised capital stock,

adapting the maximum lending volume and accepting a new member to the ESM, as well as delegating tasks to the Board of Directors.

In a number of areas the Board of Governors takes decisions by qualified majority (80% of voting rights cast). These areas include setting out the detailed terms of accession of a new member to the ESM, appointing the Managing Director, approving the annual accounts of the ESM, appointing members of the Board of Auditors, approval of the external auditors and waiving the immunity of any board official or the Managing Director.

The Board of Governors meets at least once a year and whenever the affairs of the ESM so require. In 2012, the Board of Governors met once for its inaugural meeting.

At the inaugural meeting of 8 October 2012, the Board of Governors appointed Mr Jean-Claude Juncker, in his capacity as President of the Eurogroup, as its Chairperson. At the same meeting, the Board of Governors also adopted the ESM by-laws and the Rules of Procedure for the Board of Governors and for the Board of Directors, appointed the members of the Board of Auditors, and adopted the Pricing Guideline. On the following day, 9 October 2012, a number of operational guidelines and policies were adopted by the Board of Directors.



On 11 February 2013, Mr Jeroen Dijsselbloem succeeded Mr Jean-Claude Juncker, who had stepped down as President of the Eurogroup, as Chairperson of the Board of Governors.

1.5 Board of Directors

Each Governor appoints one Director and one alternate Director from among people of high competence in economic and financial matters. The Member of the European Commission in charge of economic and monetary affairs and the President of the ECB may also appoint one observer each.

The Board of Directors ensures that the ESM is run in accordance with its Treaty and By-laws. It takes decisions as provided for by the ESM Treaty or decisions delegated to it by the Board of Governors.

Decisions are taken by qualified majority, unless otherwise stated by the ESM Treaty.

The Board of Directors meetings are chaired by the ESM Managing Director. The Board of Directors held four meetings in 2012.





The ESM is committed to the highest standards of corporate governance.

The concept of corporate governance traditionally involves a set of relationships between a company’s management, board, shareholders and other stakeholders, as well as procedures and processes according to which an organisation is directed and controlled.

ESM Voting Procedures

Board of Governors

<p>Decisions by mutual agreement (unanimity of members participating in the vote)</p>	<ul style="list-style-type: none"> Issue new shares, make capital calls, change authorised capital stock and adapt maximum lending volume Provide stability support and to establish choice of instruments and the financial terms and conditions, give mandate to EC to negotiate MoU in liaison with ECB Change list of financial instruments of ESM, modalities of transfer of EFSF support to ESM
<p>Decisions by qualified majority (80% of the votes cast)</p>	<ul style="list-style-type: none"> Technical terms of accession to ESM Set out by-laws and rules of procedure Actions to be taken for recovering a debt from an ESM member Appoint Managing Director and members of the Board of Auditors Approve annual accounts and external auditors
<p>Emergency voting procedure (85% of the votes cast)</p>	<ul style="list-style-type: none"> If European Commission and European Central Bank both conclude that a failure to urgently adopt a decision to grant or implement financial assistance would threaten the economic and financial sustainability of the euro area Provide stability support and to establish choice of instruments and the financial terms and conditions, give mandate to EC to negotiate MoU in liaison with ECB under emergency voting procedure



The Managing Director is appointed by the Board of Governors from among nationals of any ESM Member with **relevant international experience and a high level of competence** in economic and financial matters

Board of Directors

Decisions by qualified majority

(85% of the votes cast)

Decisions by BoD are taken by qualified majority unless otherwise stated by ESM Treaty

e.g. staff rules, conditions of employment of Managing Director and other staff, annual budget

Decisions by mutual agreement

(unanimity of members participating in the vote)

Maintain ESM precautionary financial assistance, adequacy of precautionary credit line or other financial support needed

ESM loans and recapitalisations of financial institutions
Disbursement of tranches subsequent to 1st tranche

Primary market support facility – disbursement of financial assistance
Secondary market support facility – initiate operations

Emergency voting procedure

(85% of the votes cast)

If European Commission and European Central Bank both conclude that a failure to urgently adopt a decision to grant or implement financial assistance would threaten the economic and financial sustainability of the euro area

Decision to disburse financial assistance under emergency voting procedure

1.6. Managing Director

The Managing Director is appointed by the Board of Governors from among candidates who are nationals of any ESM Member with relevant international experience and a high level of competence in economic and financial matters. Whilst holding office, the Managing Director may not be a Governor or Director or an alternate of either. In their inaugural meeting of 8 October 2012, the Board of Governors appointed Mr Klaus Regling as Managing Director for a renewable term of office of five years.

The Managing Director is responsible for conducting the current business of the ESM under the direction of the Board of Directors, which he chairs. He is the legal representative and the chief of staff of the ESM. Mr Regling is assisted by a Management Board.

Pursuant to Article 11 of the ESM By-laws, the Management Board assists the Managing Director in conducting the current business of the ESM, in preparing the decisions of the Board of Governors and the Board of Directors and in seeing to their implementation.

1.7. Committees of the Board of Directors

The Board of Directors established two permanent committees: the Risk Committee and the Compensation Committee. Both committees are composed of five members appointed from among the Directors for renewable terms of three years.

The Risk Committee advises the Board of Directors on the overall current and future risk appetite and strategy and assists the Board of Directors in ensuring that the strategy is implemented by the Managing Director.

The Compensation Committee advises the Board of Directors and the Managing Director in matters of staff compensation, namely periodic revision of the compensation framework, annual salary mass and evolution of salary band boundaries.

The permanent committees of the Board of Directors usually meet on a quarterly basis, or whenever the affairs of the ESM so require.

1.8. Board of Auditors

The Board of Auditors is an independent body composed of five members who are appointed by the Board of Governors for their competence in auditing and financial matters. Two members are appointed upon the proposal of the Chairperson of the Board of Governors, two members upon the nomination by the supreme audit institutions of ESM Members on a system of rotation, and one member upon the nomination by the European Court of Auditors.

The members of the Board of Auditors were appointed on 8 October 2012 for a non-renewable term of three years, except for Ms Kaszasová and Mr Graf whose names were drawn by lot to be appointed for a non-renewable term of four years. The Board of Auditors elected Mr Harald Noack as Chairperson and Ms Katarína Kaszasova as Vice-chairperson of the Board of Auditors.

The Board of Auditors inspects the ESM accounts and verifies that the operational accounts and balance sheet are in order. It informs the Board of Directors of its findings and draws up an annual report to the Board of Governors, made accessible to the national parliaments and supreme audit institutions of the ESM Members.

Following the date of inauguration on 8 October 2012, the Board of Auditors held three meetings in 2012.



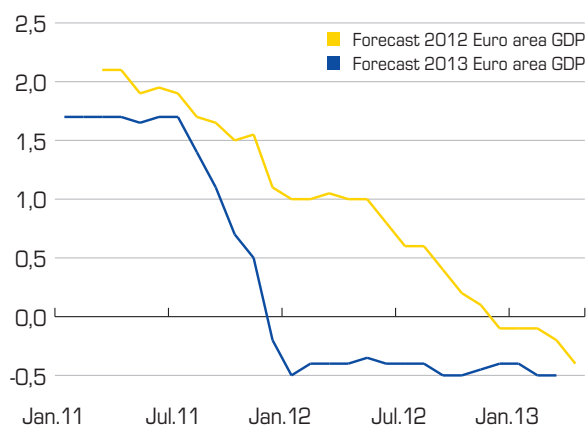
In retrospect,
the past year
represented a
turning point for
the crisis-stricken
euro-area

2. Macro-economic and Financial Environment in the Euro Area

2.1 Market uncertainty remained high in the first half of 2012

In retrospect, the past year represented a turning point for the crisis-stricken euro area. At the end of 2011, euro area governments took a series of decisions to improve public finances and restore market functioning. In December 2011, the basic outlines of a new inter-governmental treaty to implement at national level a structural balanced budget rule was agreed upon. Furthermore, the Eurosystem decided to apply two three-year long 'longer-term refinancing operations' (LTROs) in December 2011 and February 2012. The provision of liquidity reduced the risk of a banking crisis in Europe and provided help for financial institutions to cover debt coming to maturity. The measures introduced brought temporary relief in the markets in early 2012. In the latter part of March, however, optimism gradually faded as doubts over economic growth and banking sector prospects in the euro area again began to surface (Chart 1).

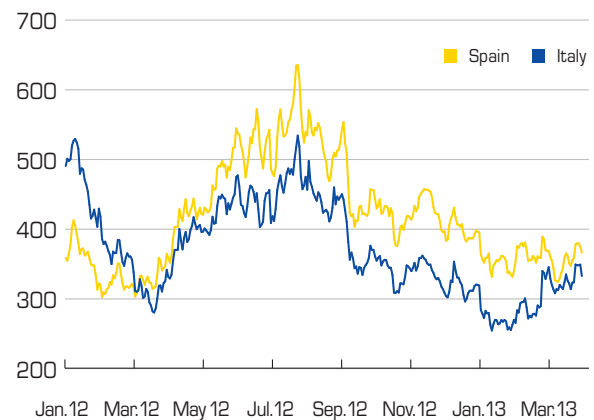
Chart 1. Evolution of euro area GDP growth expectations



Source: Bloomberg

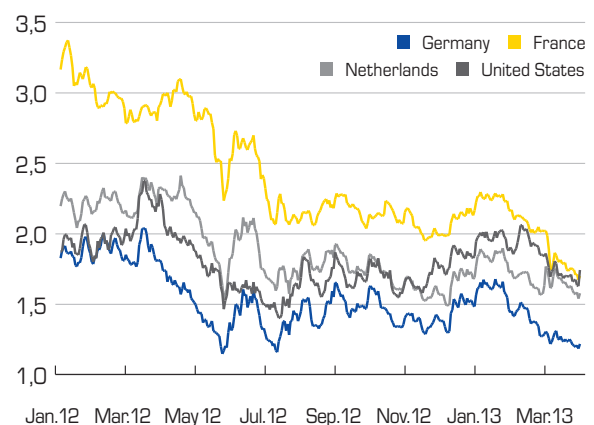
During this period and the subsequent months, spreads widened for some euro area government bonds (Chart 2). Between mid-March and the peaks recorded in late July, ten-year bond spreads vis-à-vis Germany increased by around 245 basis points in Italy and 310 basis points in Spain. Part of the reason for higher financing costs in Italy and Spain emanated from market concerns about economic fundamentals. In addition, the higher spreads in Spain partly reflected heightened concerns over the bank sector situation. In the case of Greece, political instability had brought implementation of the adjustment programme to a halt, and financial markets speculated about the country's ability to stay in EMU.

Chart 2. Spanish and Italian ten-year bond spreads vis-à-vis Germany (in basis points)



Source: Datastream

Chart 3. Long-term government bond yields in Germany, France, the Netherlands and United States (%)



Source: Datastream

However, the increase in yields and spreads during this period was to a large degree also related to a lack of confidence and risk aversion in financial markets. Investors demanded rising risk premia on bonds from peripheral countries as reward for general uncertainty. It is likely that the interaction between deteriorating confidence, investors' risk appetite and credit agencies' risk assessments created self-fulfilling prophecies about the perceived lack of debt sustainability in peripheral euro area countries during these months. While countries in the periphery saw their financing costs rising to considerable levels, bond yields for AAA-rated countries dropped significantly (Chart 3). In this climate, investors saw little alternative than to shift their funds to highly-rated euro area bonds. Between mid-March and the latter part of July, 10-year yields on German and other AAA-rated sovereign bonds declined by roughly 70 basis points as a result of the flight to safety.

Increased uncertainty spilled over to other asset classes and economies in the euro area. Stock prices across the euro area dropped, including in relation to the United States, with bank stocks leading the fall. The euro depreciated sharply during these months and stood at a level of 1.20 vis-à-vis the US dollar in late July, its lowest level since June 2010.

2.2 Signs of normalisation in the second half of 2012

In July, euro area financial market tensions peaked. By the end of June, the Spanish government submitted a request to the Eurogroup for financial assistance to support its undercapitalised banks. Euro area Member States responded favourably, with a facility of up to EUR 100 billion. At the same time, the political stalemate in Greece was overcome. Neither situation, however, stemmed market tensions immediately.

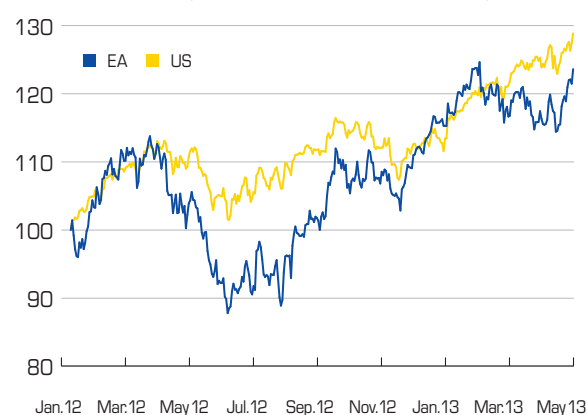
The heightened tensions in financial markets during the summer of 2012 raised awareness that decisive action was needed to strengthen the euro area's foundations over the long term. During the second half of 2012, the European authorities took a number of steps to spur market confidence. At the European Council of 28/29 June, EU leaders agreed to deepen economic and monetary union as one of the remedies to the current crisis. More specifically, the Heads of State or Government agreed to launch a process leading to the creation of a single supervisory institution and to the possibility of direct recapitalisation of banks by the ESM, in order to break the vicious cycle between the sovereigns and banking systems. In September, a concrete proposal for the single supervisory mechanism (SSM) was presented.

In addition, the ECB played an important role in alleviating financial market tensions and stimulating market recovery. Following an announcement of President Draghi in July, the ECB specified the terms of the Outright Monetary Transactions programme (OMT) in September. The OMT would only apply to countries receiving EFSF/ESM financial assistance under a full macroeconomic adjustment programme or a precautionary programme (ECCL - Enhanced Conditions Credit Line), provided that they include the possibility of EFSF/ESM primary market purchases. The ECB explicitly mentioned that no ex-ante quantitative limits would be set on the size of OMT.

The decisions of the EU leaders and the OMT announcement by the ECB were a game changer in financial markets, supported by the ongoing reduction of imbalances in borrowing countries. The move toward a banking union in the euro area was well perceived among market participants, seen as reducing risks relating to the sustainability of sovereigns and the financial system. In addition, ECB action reassured investors that it would act against any excessive risk premia in euro area sovereign bonds for

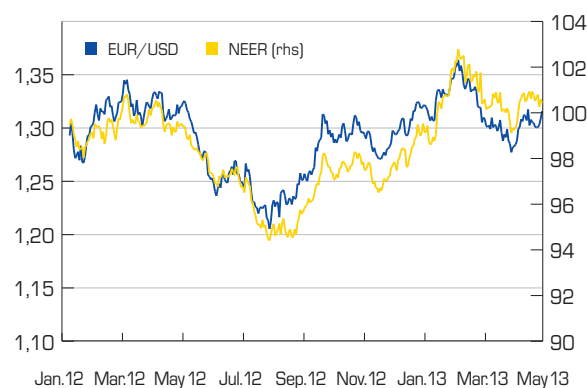
countries under an adjustment programme or an ECCL. As a result, bond yields and spreads vis-à-vis Germany sharply declined in the periphery and countries following EU/IMF programmes. In Italy and Spain, ten-year bond spreads dropped by around 215 and 240 basis points, respectively, between the peaks reached in late July and the end of December 2012. Euro area stock prices rose by nearly 30% over the same period (Chart 4). Increased confidence in the euro area as an investment alternative was also reflected in capital inflows and an appreciation of the euro exchange rate (Chart 5).

Chart 4. Stock prices in the euro area and United States (indexed to 100, 1 Jan 2012)



Source: Datastream

Chart 5. EUR/USD and euro nominal effective exchange rate (NEER)

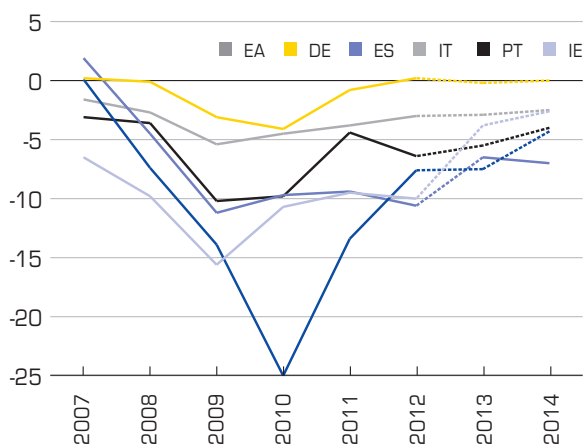


Source: Bloomberg

In parallel, economic reforms at country level started bearing fruit, and further progress was made. Borrowing countries improved their competitiveness and reduced current account as well as fiscal deficits (Charts 6-7). More generally, market sentiment was bolstered by improvements in competitiveness in countries where, over the previous decade, wage growth had grown faster than

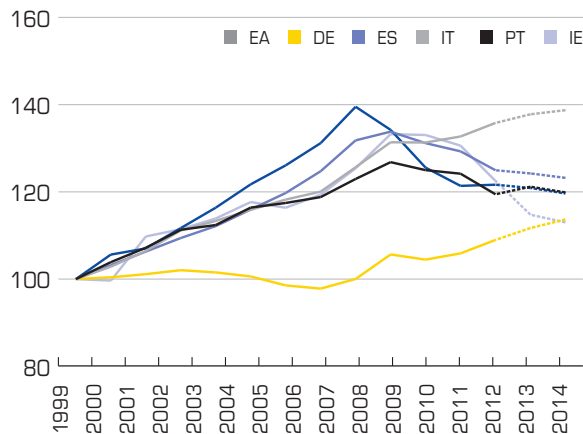
productivity, resulting in unfavourable unit labour cost dynamics. The improvement in competitiveness for countries under EU/IMF programmes was particularly welcome and stemmed partly from structural reforms undertaken to improve the shock-absorbing capacity of the economy. These reforms included wage-setting mechanisms that were more responsive to firm and country-specific economic conditions, the removal of general barriers to hiring and firing and also measures to enhance domestic and foreign competition in product markets.

Chart 6. Fiscal balance, euro area Member States (as % of GDP)



Source: Eurostat and European Commission, Spring forecast 2013

Chart 7. Unit labour cost in the euro area (indexed to 100, 2000)



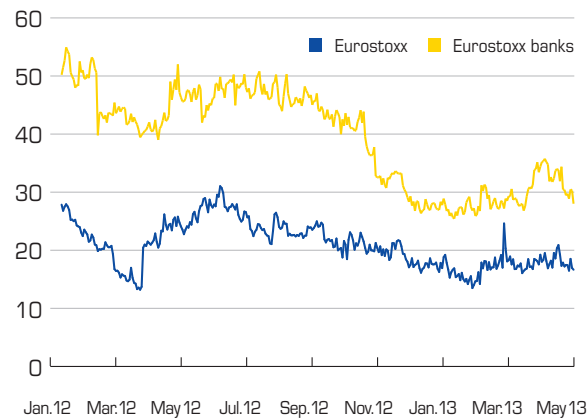
Source: European Commission Spring 2013 forecast and ESM calculations

In the latter part of 2012, uncertainty surrounding Greece receded. A three-party coalition government, emerging from the June elections, put the programme back on track, after extensive negotiations with the Troika institutions lasting nearly 5 months. In December, euro area leaders and the IMF agreed on a range of measures

to get the country back on a sustainable debt footing – including a reduction in fees and interest rates, the extension of loan maturities, deferral of interest payments by 10 years and a debt buy-back operation. This set of measures, coupled with a strong political commitment at home to implementing further reforms, helped boost market confidence, including outside of Greece.

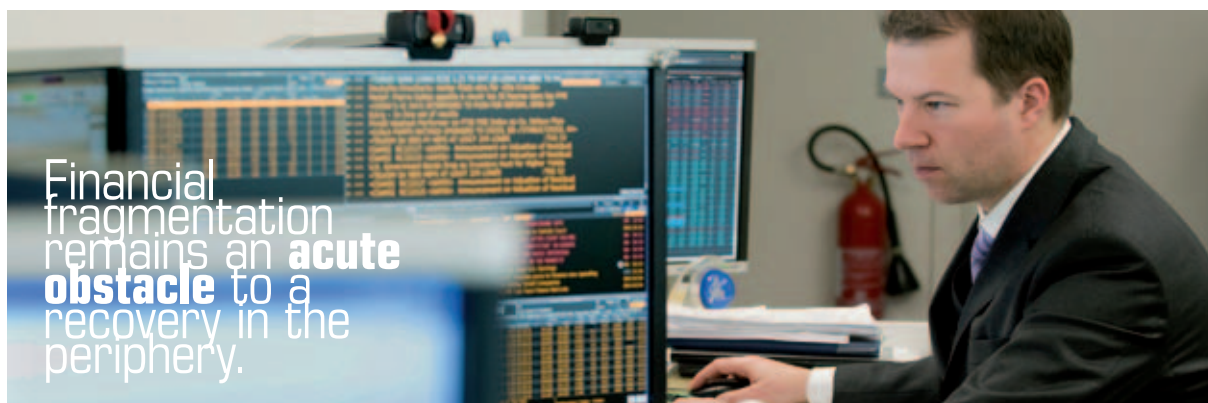
In addition, confidence in the euro area as a whole was supported by developments in Ireland and Portugal. The two economies completed all their reviews successfully and within their respective deadlines in 2012, in spite of growth rates falling short of initial projections and strong headwinds from a more challenging external environment. Improved market confidence allowed them a partial return to market funding, ahead of schedule. Both countries have successfully issued medium-term debt since the summer of 2012, albeit in limited amounts. The completion of the reviews, coupled with early bond issuance, increase the likelihood that these countries will be able to return to full market financing at the end of their respective economic adjustment programmes.

Chart 8. Implied volatility on euro area stock prices and euro area banks' stock prices



Source: Bloomberg

Finally, the institutional policy initiatives also contributed to financial stability in the euro area. Beyond progress towards a banking union, the creation of the ESM – as a permanent crisis resolution fund to provide financial assistance under strict conditionality, appropriate to the financial assistance instrument chosen, to euro area countries in temporary need of assistance – and the announcement of the OMT instilled market confidence. Moreover, market sentiment benefited from strengthened capital positions in banks, coupled with reduced leverage. As regards leverage, countries under EU/IMF programmes made substantial progress in reducing their loan-to-deposit ratios to levels in line with programme recommendations. Stock prices and credit risk indicators for large and systemically important banks recovered. The implied volatility of bank equity indices in the euro area – a measure of the expected oscillations in large banks' stock prices – fell sharply in second half of 2012



(Chart 8). It remained higher, however, than that of broad market indices, indicating that uncertainty regarding the outlook for the banking sector remained higher than that in other economic sectors.

Despite the overall improvement in the macroeconomic environment and market confidence, renewed uncertainty emerged in early 2013. Over the first three months of 2013, the risk premium attached to euro area financial asset prices rose again and contributed to higher yield spreads while the euro exchange rate gave up some of its earlier gains. This shift in sentiment resulted from subdued economic growth in the euro area and political uncertainty in Italy. In late March, euro area finance ministers and the IMF agreed on a EUR 10 billion rescue package for Cyprus. In order to avoid the sovereign debt relative to GDP reaching unsustainable levels, the package included a bail-in of uninsured bank depositors.

Although the measures to bail-in depositors created some general uncertainty of how policy makers would deal with bank bailouts going forward, financial market sentiment improved somewhat in April following successful bond auctions in the periphery coupled with the anticipation that monetary policy would provide further support to the euro area economy.

2.3 Risks to the outlook remain elevated going forward

Looking ahead, despite the tangible progress made in the second half of 2012, important challenges remain. GDP growth forecasts from international organisations and the private sector suggest that the euro area economy will continue to contract in 2013. Unemployment remains high and rising, standing at 12.1% in March. Reform efforts must continue if competitiveness is to be improved across most of the euro area. Furthermore, financial fragmentation remains an acute obstacle to a recovery in the periphery. Bank lending rates for firms and house-

holds in the periphery and countries under EU/IMF adjustment programmes are substantially higher than interest rates charged to firms and households in other euro area countries.

In order to boost potential growth, enhance job creation, improve competitiveness, reduce financial fragmentation and strengthen public support for monetary union, euro area Member States need to continue their efforts with fiscal consolidation and structural reforms. EU initiatives such as the strengthened Stability and Growth Pact, the Treaty on Stability, Coordination and Governance in the EMU (“fiscal compact”), the European Semester, the Euro Plus Pact and the new European system of financial supervision are important elements contributing to the financial stability of the euro area.

In this context, completion of the banking union is paramount in order to break the vicious circle between sovereign and banking risks. Concluding the legislative process on the Single Supervisory Mechanism (SSM) should allow for its operationalisation by July 2014. As agreed by the European Council in December 2012, when an effective SSM is established, the ESM will, following a regular decision, have the possibility to recapitalise banks directly.

Furthermore, the Commission intends to submit by summer 2013 a legislative proposal on a Single Resolution Mechanism for countries participating in the SSM, to be examined as a matter of priority with the intention of adopting it during the current parliamentary cycle. It should ensure an effective framework for resolving financial institutions while protecting taxpayers in the context of banking crisis, be based on contributions from the financial sector itself and include appropriate and effective backstop arrangements.”



The objective of the loans associated to a macro-adjustment programme is to **provide financing to ESM Members**, which have to a large extent lost access to markets, with economic conditions attached

3. Policies and Guidelines

3.1 Stability support loans within a macro-economic adjustment programme

The objective of loans associated to a macro-adjustment programme is to assist ESM Members in significant need of financing, but which have to a large extent lost access to the markets, whether because they cannot find lenders or because lenders will provide financing only at excessive prices that would adversely impact the sustainability of public finances.

In order to ensure a return to full market financing and a sustainable economic and financial situation, all loans are subject to a macroeconomic adjustment programme which includes appropriate conditionality prepared by the Commission, in liaison with the ECB and, where appropriate, the IMF. Such conditionality is set out in the MoU between the requesting ESM Member, its central bank, the European Commission.

The European Commission, in liaison with the ECB, and wherever possible, the IMF, is entrusted with monitoring compliance with the conditionality. The beneficiary ESM Member is obliged to provide these institutions with all the information necessary for monitoring the policy conditionality of the programme agreed in the MoU. The beneficiary State also needs to provide the ESM all information necessary for performing financial due diligence.

Loans are provided in tranches, which may each consist of one or more disbursements. The disbursement of the first tranche is decided by the Board of Directors together with the approval of the Financial assistance Facility Agreement (FFA). A decision regarding the disbursement of subsequent tranches of financial assistance will subsequently be taken by the Board of Directors on a proposal from the Managing Director, and after having received a report from the European Commission on the compliance by the beneficiary ESM Member with the policy conditionality attached to the FFA.

If monitoring processes highlight significant deviations from the macroeconomic adjustment programme, the Board of Governors may conclude that the beneficiary ESM Member does not comply with the policy requirements set out in the programme. In such cases, disbursements of a tranche will be withheld until the Board of Governors decides to re-authorise them.

3.2 Financial assistance for the purpose of recapitalisation of Financial Institutions

The aim of a loan for recapitalising financial institutions is to preserve the financial stability of the euro area as a whole and of its Member States by addressing those specific cases in which the roots of a crisis situation are primarily located in the financial sector and not directly related to fiscal or structural policies. Such assistance is thus provided in order to limit the contagion of financial stress by ensuring the capacity of a beneficiary ESM Member's government to finance recapitalisation at sustainable borrowing costs and facilitate financial sector repair so that vulnerabilities are eliminated. Loans to ESM Members for the recapitalisation of financial institutions are generally made in kind, i.e. through the transfer of ESM notes.

The beneficiary Member State should demonstrate the lack of alternatives for recapitalising the financial institution(s) concerned: this means first an inability to meet capital shortfalls via private sector solutions (e.g. tapping new market investors or existing shareholders) and, second, an inability to recapitalise the institution(s) without generating adverse effects for its own financial stability and fiscal sustainability.

In addition, the financial institution(s) concerned should be of systemic relevance or pose a serious threat to the financial stability of the euro area or its Member States. Their systemic dimension will be assessed, taking into account primarily their size, interconnectedness, complexity, and substitutability.

Finally, the beneficiary ESM Member should also demonstrate its ability to reimburse the loan granted, even in cases in which it would not be able to recover the capital injected in the beneficiary institution(s) according to the timing agreed in relevant state-aid decisions. The beneficiary will also have to demonstrate the existence of a sound fiscal and macroeconomic policy record.

Unlike stability support within a macro-economic adjustment programme, the policy conditionality focuses on the financial sector of the country in question. Conditionality will apply in the domains of financial supervision, corporate governance and domestic law relating to restructuring/resolution. The policy conditions are specified in a MoU negotiated by the European Commission in liaison with the ECB and a relevant European Supervisory Authority (EBA, ESMA or EIOPA).



The aim of financial assistance to **recapitalise financial institutions** is to preserve the financial stability of the euro area.

Compliance with institution-specific conditionality related to EU state aid rules is enforced by the European Commission, which will also be responsible for the monitoring of other policy conditions in liaison with the ECB and the relevant European Supervisory Authority (ESA). The ESAs have the right to conduct on-site inspections in any beneficiary financial institution(s) in order to adequately monitor compliance with conditions, and share information relevant for reporting on compliance with the European Commission and the ECB. Where deemed necessary, the monitoring institutions are also authorised to involve other relevant experts, such as external auditors or monitoring trustees. An additional assessment by the IMF of the implementation of international standards and supervisory practices is actively sought by the beneficiary ESM Member during the period of implementation of the financial assistance.

3.3. Precautionary Financial Assistance

The objective of ESM precautionary financial assistance in the form of credit lines is to support sound policies and prevent crisis situations from emerging by allowing ESM Members to secure ESM assistance before they face major difficulties in raising funds on capital markets. Precautionary financial assistance aims to help ESM Members whose economic conditions are still sound to maintain continuous access to market financing by strengthening the credibility of their macroeconomic performance while ensuring an adequate safety net.

Two types of ESM credit lines are available: a Precautionary Conditioned Credit Line (PCCL) and an Enhanced Conditions Credit Line (ECCL). PCCL and ECCL credit lines can be drawn via a loan or a primary market purchase. Both types of credit line have an initial availability period of one year and are renewable twice, each time for six months.

Precautionary conditioned credit line (PCCL) – available to a euro area Member State whose economic and financial situation is fundamentally sound, as determined by respecting eligibility criteria (sustainable public debt, respect of commitments under excessive deficit procedure, track record of access

to capital markets on reasonable terms, sustainable external position and the absence of bank solvency problems that would pose systemic threats to the stability of the euro area banking system). The beneficiary country is obliged to respect the eligibility criteria after the PCCL is granted.

Enhanced conditions credit line (ECCL) – Access open to all euro area Member States whose general economic and financial situation remains sound but which do not comply with some of the eligibility criteria for accessing a PCCL. The beneficiary ESM Member is obliged to adopt corrective measures aimed at addressing such weaknesses and avoiding any future problems in respect of access to market financing, while ensuring continuous adherence to the eligibility criteria which were considered met when the credit line was granted.

Once granted, a credit line is activated at the initiative of the beneficiary ESM Member. The ESM Member has the flexibility to request the draw-down of funds at any time during the availability period of the credit line, in accordance with the agreed terms.

When an ECCL is granted or a PCCL drawn, the ESM Member is subject to enhanced surveillance by the European Commission regarding the availability period of the credit line. The scope of surveillance includes information regarding the beneficiary country's financial condition and developments in its financial system. On a request from the European Commission, the beneficiary ESM Member is also required to carry out stress tests or sensitivity analyses to assess the resilience of the financial sector to various shocks and be subject to regular assessments of its supervisory capacities over the banking sector in the form of a peer review carried out by the relevant ESA. In addition, the beneficiary country is obliged to carry out and report on a comprehensive independent audit of the government's accounts in coordination with national supreme audit institutions, aiming to assess the reliability, completeness and accuracy of these public accounts for the purpose of the excessive deficit procedure.

3.4. Primary Market Bond Purchase Facility

The ESM may engage in primary market purchases of bonds or other debt securities issued by ESM Members to allow them to maintain or restore their relationship with the dealer/investment community and therefore reduce the risk of a failed auction.

Bond purchase operations in the primary market could be made to complement regular loans under a macroeconomic adjustment programme or the drawdown of funds under a precautionary programme. In the former case, this instrument would be primarily used towards the end of an adjustment programme to facilitate a country's return to the market.

The conditionality related to the Primary Market Bond Purchase facility would be that of the underlying macroeconomic adjustment programme or precautionary programme.

Primary market purchases will be conducted at market prices. The means of implementation will depend on the issuance approach taken by the ESM Member:

Via a participation in auctions, at the average weighted price of the auction. The amount purchased by the ESM will, as a rule, be limited to 50% of the final issued amount. This proportion will, however, be increased if market bids at acceptable prices are insufficient, with a view to ensuring that the amount sold by the beneficiary ESM Member is equivalent to at least half of the originally targeted amount.

Via participation in syndicated transactions, at the re-offer price. The amount purchased by the ESM will, as a rule, be limited to 50% of the final issued amount. This proportion will, however, be increased if the order book is insufficient, with a view to ensuring that the amount sold by the beneficiary ESM Member is equivalent to at least half of the originally targeted amount.

The primary market purchase would not be carried out if the ESM's Managing Director concluded that the participation of private investors would be insufficient or the rate would be excessively above the ESM funding rate. Where appropriate, the purchase of bonds would then be replaced by a regular drawdown of funds.

Once purchased by the ESM, securities can be: i) resold to private investors when market conditions have improved; ii) held until maturity; iii) sold back to the beneficiary ESM Member; or iv) used for repos with commercial banks to support liquidity management of the ESM.

3.5. Secondary Market Bond Purchase Facility

The Secondary Market Bond Purchase facility aims to support the sound functioning of the government debt markets of ESM Members in exceptional circumstances where the lack of market liquidity threatens financial stability, with a risk of pushing sovereign interest rates towards unsustainable levels and creating refinancing problems for the banking system of the ESM Member concerned. An ESM secondary market intervention is designed to enable market-making that would ensure some debt market liquidity and incentivise investors to further participate in the financing of ESM Members.

Secondary market support could be provided for ESM Members under a macroeconomic adjustment programme and also for non-programme Members whose economic and financial situation is fundamentally sound, as determined by respecting eligibility criteria (sustainable public debt, respect of commitments under excessive deficit procedure, the track record of access to capital markets on reasonable terms, a sustainable external position and the absence of bank solvency problems that would pose systemic threats to the stability of the euro area banking system).

For countries under a macroeconomic adjustment programme, the conditionality relating to that programme applies. For ESM Members outside of a macroeconomic adjustment programme, the European Commission, in conjunction with the ECB, would negotiate a MoU detailing the policy conditions with the ESM Member concerned.

As with purchases in the primary bond market, securities purchased by the ESM on the secondary bond markets can be either resold to private investors upon improved market conditions, be held until maturity, sold back to the beneficiary country or used for repos with commercial banks to support ESM's liquidity management.



During 2012, the only financial facility provided by the ESM was the Financial Assistance Facility Agreement signed with Spain

4. Lending Activities

During 2012, the only financial facility provided by the ESM was the Financial Assistance Facility Agreement signed with Spain on 29 November 2012, which included a Financial Institution Recapitalisation Facility for a total amount of EUR 100 billion¹, with a maximum maturity of 15 years and a maximum average maturity of 12.5 years.

Originally, a similar facility had been signed with Spain on 24 July 2012 under the EFSF. This initial EFSF facility included two important characteristics: i) it envisaged a pre-funded tranche of EUR 30 billion to create a backstop facility of a contingent nature to cover unexpected interventions, and ii) it provided for the possibility of transferring the facility from the EFSF to the ESM once the ESM had been established. In relation to the first point, the pre-funded tranche was created but never requested under the EFSF, and therefore it was subsequently cancelled on 12 December 2012, at which point ESM funding had already been made available.

Concerning the transfer of the facility to the ESM, it was agreed that the financial and commercial terms agreed under the EFSF facility would be respected in the ESM lending documents, which were adapted accordingly². In line with the ESM Pricing Policy, a margin of 30bps is applicable to the Financial Institutional Recapitalisation Facility for Spain.

The first disbursement under the Spanish facility was made on 11 December 2012 for a total amount of EUR 39.468 billion through the delivery of ESM bonds.³ The bonds were provided to the Bank of Spain, which received them on behalf of the Kingdom of Spain, and subsequently transferred to the FROB⁴, which in turn used them to recapitalise the four financial institutions it had taken over (Group 1 banks) as well as the SAREB⁵ (please see table 5 below).

Table 5. Funds requested by the Kingdom of Spain for Group 1 Banks and SAREB⁶

Institution	Amount (EUR)
BFA-Bankia	17 959 000 000
Catalunya Caixa	9 084 000 000
NCG Banco	5 425 000 000
Banco de Valencia	4 500 000 000
SAREB	2 500 000 000

1 EUR 100 billion is the maximum available amount for this facility.

2 For example, the Financial Assistance Facility Agreement for Spain specifies that its obligations under the Financial Institutions Recapitalisation Facility signed with the ESM "will rank *pari passu* with all other present and future unsecured and unsubordinated loans and obligations of the Beneficiary Member State arising from its present or future Relevant Indebtedness".

3 It is usual practice for the EFSF and ESM to disburse funds for bank recapitalisation in the form of bonds instead of cash, as the recapitalised banks may obtain liquidity from these ESM bonds through repo transactions.

4 The FROB (Fondo de Reestructuración Ordenada Bancaria) is the restructuring and bank recapitalisation fund established in Spain.

5 SAREB (Sociedad de Gestión de Activos de la Reestructuración Bancaria) is the asset management company set up by Spain in order to acquire certain real estate-related assets from recapitalised banks.

6 As per Request for Funds of 3 December 2012.

The second disbursement under the Spanish facility was made on 5 February 2013 for a total amount of EUR 1.865 billion, again through the delivery of ESM bonds, and according to a similar procedure as the one described above. The funds were used to recapitalise four additional Spanish banks, which could not reach the required capital levels through other means (Group 2 banks; please see table 6 below). The capital injection made by the FROB in both Group 1 and Group 2 banks was done either in tangible capital or CoCos (Contingent Convertible bonds⁷), depending on the circumstances of each bank.

Table 6. Funds requested by the Kingdom of Spain for Group 2 Banks⁸

Institution	Amount (EUR)
Banco Mare Nostrum	730 000 000
Banco Ceiss	604 000 000
Caja 3	407 000 000
Liberbank	124 000 000

During the first months of 2013, the ESM has also been negotiating a Financial Assistance Facility Agreement with the Republic of Cyprus in view of contributing to the support of a macroeconomic adjustment and bank restructuring programme. At its meeting of 25 March 2013, the Eurogroup agreed to provide financial assistance to the Republic of Cyprus, in principle, for a total amount of up to EUR 10 billion, of which about EUR 1 billion is to be contributed by the IMF. The ESM loan facility has an average maturity of 15 years and a maximum maturity of 20 years. The funds are to be used for financing government expenditures, debt redemptions, and for bank recapitalisation with the exception of the Cyprus Popular Bank (CPB) and Bank of Cyprus (BoC). CPB was resolved by transferring assets, insured depositors, interbank liabilities, and Emergency Liquidity Assistance to the BoC. The BoC was recapitalised by the bail-in of shareholders, junior bondholders, senior creditors and a partial bail-in of uninsured depositors.

The relevant national procedures and necessary institutional approvals for this Financial Assistance Facility (ESM Board of Governors and ESM Board of Directors) were finalised during the beginning of May 2013, together with the authorisation of a first tranche of assistance of up to EUR 3 billion to be disbursed in May and June 2013.

Moreover, Heads of State or Government have stated that the ESM loans will enjoy preferred creditor status in a similar fashion to those of the IMF, while accepting preferred creditor status of the IMF over the ESM.⁹

7 CoCos are bonds which may be converted into capital upon the materialisation of certain triggers/events/conditions.

8 As per Request for Funds of 28 January 2013.

9 According to the TFSM, recital 13, in the event of ESM financial assistance in the form of ESM loans following a European financial assistance programme existing at the time of the signature of this Treaty, the ESM will enjoy the same seniority as all other loans and obligations of the beneficiary ESM Member, with the exception of the IMF loans. In addition, the Eurogroup decided on 29 June 2012 that, in the case of Spain, "the financial assistance will be provided by the EFSF until the ESM becomes available, and that it will then be transferred to the ESM, without gaining seniority status".



In 2013, the ESM will
also be responsible for
the financing of the
macroeconomic
adjustment programme
for the Republic of
Cyprus

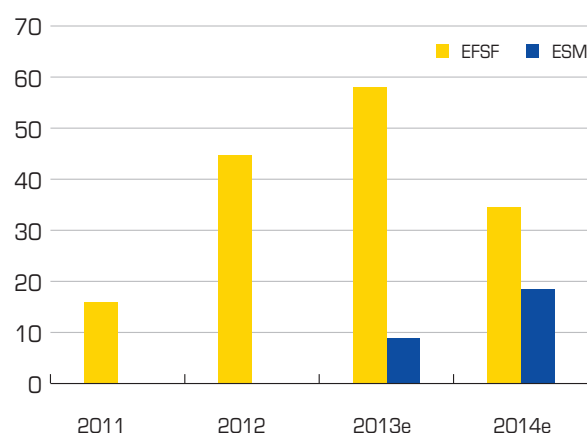
5. Funding Activities

The ESM employs a diversified funding strategy. This means that funds raised are not attributed to a particular country, but pooled and then disbursed to beneficiary countries, in the context of an agreed programme. The funds will mainly be raised by a combination of long-term and short-term funding instruments.

The long-term funding instruments will include benchmark bonds issued via syndication, taps of existing bonds through auctions and syndication and, at a later stage, private placements.

The short-term funding comprises the issuance of bills, typically using the Deutsche Bundesbank Eurosystem (EBS) auction system. Bill auctions are held on a regular basis. The ESM also has the opportunity to use money market lines with participating euro area debt management offices and participating commercial banks.

Chart 9: Expected Long-Term Funding for ESM* and EFSF



* ESM will also finance the macro-economic assistance for Cyprus for an envisaged amount of around EUR 9 bn of which EUR 3 bn is expected to be provided in May and June 2013.

5.1. Funding Review 2012

Long-Term Funding

The ongoing macro-economic adjustment programmes for Ireland, Portugal and Greece will continue to be financed by the EFSF.

In order to finance the initial disbursement of EUR 39.5 billion to Spain for the recapitalisation of its banking sector, the ESM carried out its first operations on 5 December 2012, with the issuance of two bills and 3 floating rate notes.

The securities, for a total amount of EUR 37 billion, were transferred to the bank recapitalisation fund of the Spanish government (FROB) on 11 December and subsequently passed on to the designated banks. The banks may not sell these securities outright on the market. However, they may use them to obtain liquidity from either the ECB, the national central bank or by entering into repurchase agreements with market counterparties. The remaining amount of EUR 2.5 bn was used by FROB to capitalise SAREB, the asset management company.

Table 7. Notes disbursed in 2012 for the recapitalisation of the spanish banking sector

ISIN Code	Issuance date	Maturity	Type	Amount
EU000A1U97C2	05/12/2012	11/02/2013	2 month bill	EUR 1.865bn
EU000A1U97D0	05/12/2012	11/10/2013	10 month bill	EUR 2.5bn
EU000A1U98U2	05/12/2012	11/06/2014	18 month FRN	EUR 6.468bn
EU000A1U98V0	05/12/2012	11/12/2014	2 year FRN	EUR 12bn
EU000A1U98W8	05/12/2012	11/12/2015	3 year FRN	EUR 12bn



Our **diversified funding strategy** means that funds are not attributed to a particular country

5.2. Funding Outlook 2013

In 2013, ESM will finance the rollover of the two above-mentioned bills. It will also be responsible for the financing of the macroeconomic adjustment programme for the Republic of Cyprus.

ESM is expected to provide approximately EUR 9 billion for this programme until 2015, and the International Monetary Fund is to contribute around EUR 1 billion. The ESM is expected to provide EUR 3 billion in May and June 2013.

Short-Term Funding

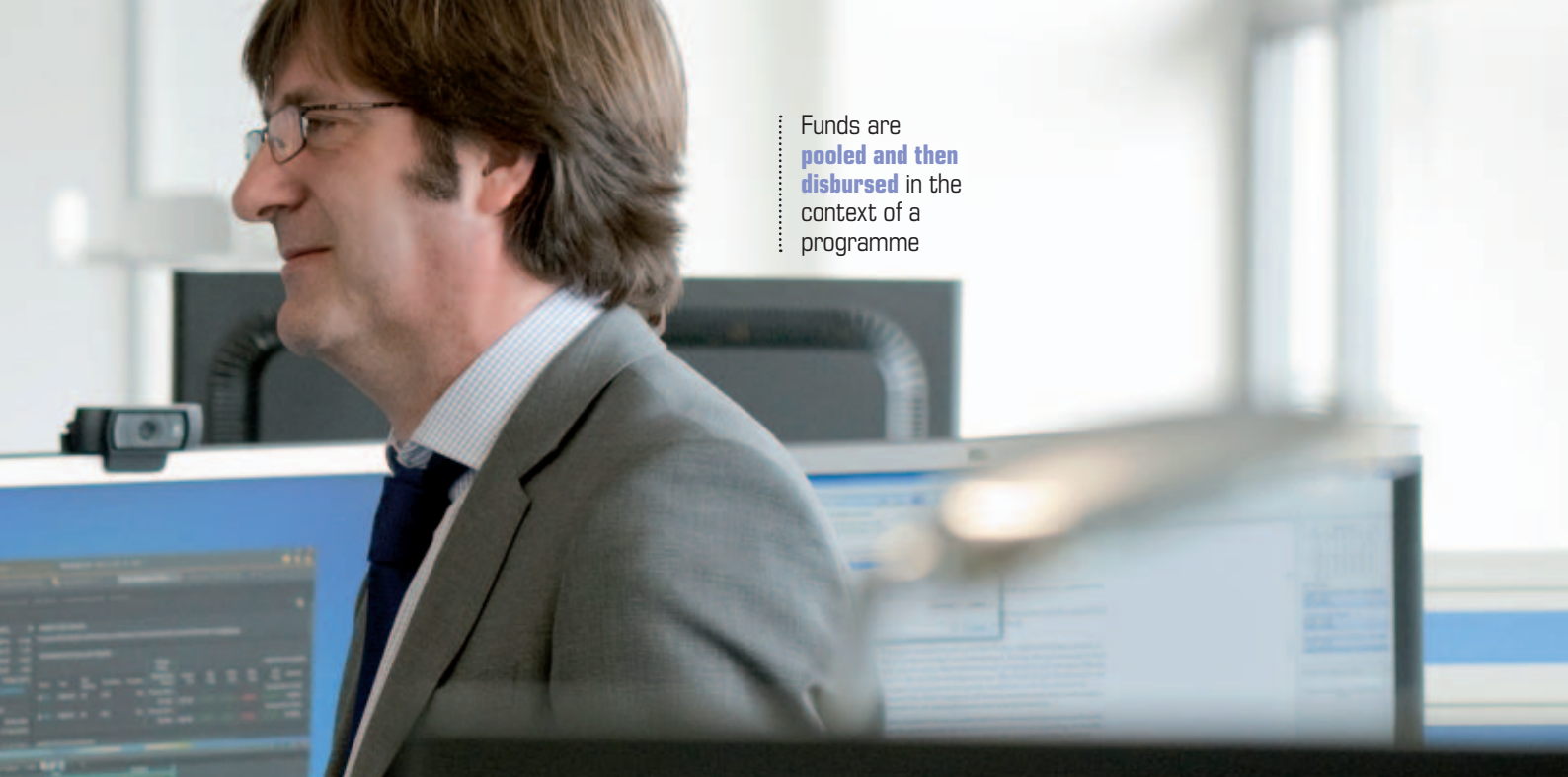
On 8 January 2013, the ESM launched its short-term funding programme with a 3-month bill auction. This new ESM bill programme has replaced the EFSF bill programme. All maturing EFSF bills will be financed via long-term funding, or temporarily via the Transitional Portfolio through the proceeds of ESM bills as approved by the ESM Board of Directors on 29 November 2012. In regular auctions of 3-month and 6-month bills, the ESM raised EUR 11.7 billion in the first quarter of 2013.

The ESM will continue to hold regular bill auctions throughout the year. The auction calendar is announced in advance for the following quarter.

Long-Term Funding

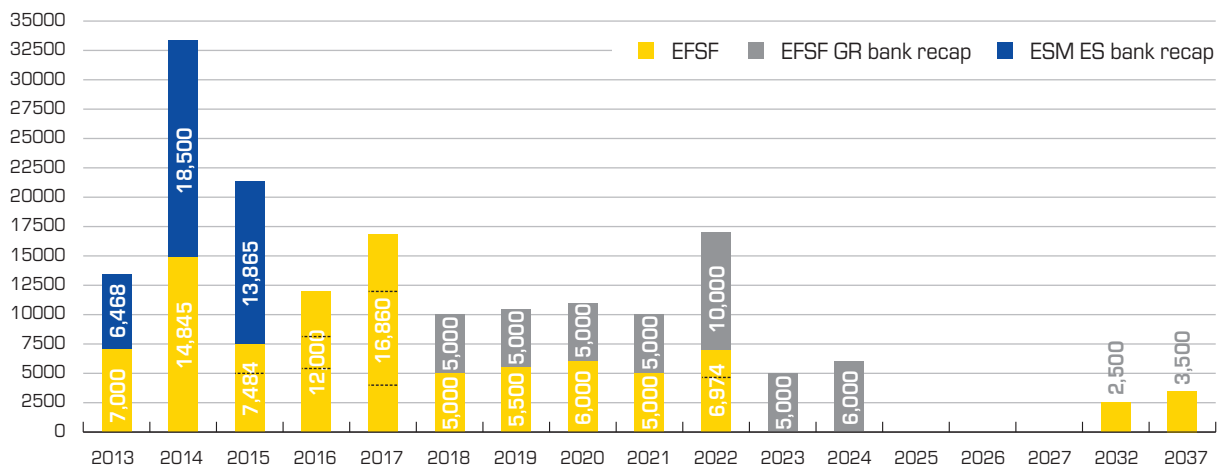
The ESM continued to fund Spanish bank recapitalisation by disbursing a 30-month floating rate Note which, as with the previous operations in December, was transferred to the FROB.

In view of its current funding requirements for 2013, the ESM will finance the rollover of maturing bills issued for the Spanish bank recapitalisation on top of the disbursements programme to Cyprus. These will be rolled over into long-term funding. As a new issuer in the supranational segment, the ESM is expected to issue benchmark bonds in the second half of the year, in order to focus on building up a yield curve and provide investors with a wide range of investment opportunities.



Funds are pooled and then disbursed in the context of a programme

Chart 10. EFSF & ESM Maturity Profile*



*As of March 2013. For EFSF, bonds only

5.3 Rating

The ESM is a strong player in the capital markets. It has a Fitch long-term rating of AAA with a stable outlook and as short-term rating of F1+. It also has a Moody's long term rating of Aa1, negative outlook, and P-1 short-term rating. S&P has currently not assigned a rating to the ESM.

The ESM's very high credit ratings reflect the institution's strong support by its shareholders with sound creditworthiness. The euro area Member states rated AA- or better by Fitch provide 62% of ESM callable capital. In addition, the ESM exhibits a low leverage, having a maximum lending capacity of EUR 500 billion and subscribed capital of EUR 700 billion. When all instalments of capital have been made, the ESM will have a higher paid-in capital (EUR 80 billion,) than any other International Financial Institution worldwide.

The rating agencies also note positively that the paid-in capital will not be used for lending purposes but invested conservatively. This will ensure that ESM maintains a strong liquidity situation. Furthermore, ESM benefits from an exceptionally strong and unique callable capital mechanism which allows the ESM's Managing Director to call capital to avoid a default of the ESM on its payment obligations without requiring approval by the Board of Governors and Board of Directors. Finally, the rating agencies mention the ESM's overall institutional strength as an International Financial Institution under public international law as a credit enhancing feature.

A man in a dark suit is walking from left to right in a modern office hallway. In the background, there is a large, vibrant green living wall. The office has light-colored walls, a wooden floor, and a dark grey carpet. A light blue architectural element is visible in the foreground on the left.

In its investment
activities, the ESM
aims **to ensure capital
preservation** and to
be a neutral market
participant

6. Investment and Treasury Policies

Investment and treasury decisions are overseen by an Investment Management Committee chaired by the Chief Financial Officer. An Internal Risk Committee, chaired by the Head of Risk, verifies that all investments conform to ESM risk policy. In addition, these two Committees are supervised by the Finance Committee, chaired by the Managing Director.



The ESM investment policy defines the overall framework within which the ESM carries out investment and treasury management.

The investment policy contributes towards the effectiveness of the ESM, and is implemented in a prudent manner contributing towards efficient and flexible portfolio management. More specifically, ESM Investment Policy ensures that the maximum lending capacity is available, and to absorb potential losses, by preserving the paid-in capital.

The Managing Director is responsible for implementing the investment policy and for setting up the appropriate governance framework.


ESM Investment and Treasury Activities

Article 6 of the ESM Investment Policy stipulates that “the Managing Director shall ensure a smooth implementation of the ESM Investment Policy guidelines, once paid-in capital has been paid. As an immediate investment of the capital payments along the targeted Investment Policy might lead to market price impacts, some temporary divergence, namely a higher share in short term and very liquid assets, shall be tolerated”.

ESM investment strategy in 2012 was largely shaped by the payment of the first two EUR 16 billion instalments of paid-in capital by ESM Members in October. As the ESM aims to ensure capital preservation, to reduce its market risk exposure, but also to be a neutral market participant, a process was designed to ensure all these objectives. The strategy was designed to avoid any excessive investment at any time in order not to alter market prices, and the paid-in capital has been invested progressively and cautiously with a significant part being at the beginning invested in official sector deposits, enabling to spread over time the investment in securities.

More specifically, the last quarter of 2012 was marked by a low yield environment in debt markets, with negative yields for many eligible instruments in the maturity range below one year, and only marginally positive yields in the maturity range up to two years. As the very low yield environment increased the risk of a negative return, the paid-in capital was invested in a variety of instruments, namely debt securities, but also in deposits with official credit institutions, to ensure the goal of capital preservation while reducing ESM market risk exposure. The non-invested funds remained secure in the ESM’s bank accounts. All ESM investment and treasury activities were thoroughly reviewed thanks to a wide range of controls carried out by the middle office to ensure the full compliance of these activities with the policy framework.

During the first quarter of 2013, the same investment strategy was followed, focusing on investing the remaining funds which had not been invested at the end of 2012, taking into consideration the fact that the market environment became slightly more attractive for investment. With such a strategy, potential market disturbances could be avoided despite the relatively large amounts invested. A similarly prudent and neutral investment strategy will be implemented as regards the further instalments of the paid in-capital. The third instalment was paid in at the end of April 2013, while the remaining two instalments are expected to be paid in October 2013 and in the first half of 2014, respectively.

A man with a shaved head, wearing a blue and white striped dress shirt and a blue patterned tie, is shown in profile, looking towards the right. The background is blurred, suggesting an indoor setting like a conference or meeting.

The ESM **does not**
aim to generate profit
on financial support
granted to beneficiary
member states

7. Risk Management

7.1. Introduction

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

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

- To follow a prudent approach to risk-taking in order to limit potential losses and to ensure continuity in fulfilling the ESM's mandate and meeting its commitments
- To maintain minimum capital requirements¹⁰ in order to ensure the highest creditworthiness and to avoid unexpected capital calls
- To preserve the ESM's funding, and hence lending, capacity

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

7.1.1. Risk Governance

The mechanisms for the governance of risk management within the ESM include the various committees or decision bodies responsible for adherence and conformity with the ESM risk management framework as well as how authority for decisions is delegated.

The Board of Governors delegates authority and accountability for establishment of the ESM risk management framework to the Board of Directors and implementation to the Managing Director. In addition, the Board of Directors has also established two risk committees.

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

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

7.1.2. Risk Appetite

A Risk Appetite Statement has been developed for the ESM to provide a statement of the appetite for risk that the ESM Board of Directors (referred to as "we" in the guiding principles below) is willing to accept in the execution of the organisation's mandate. This risk appetite is then cascaded by ESM Management and the Risk Department into relevant aspects of governance, policies, frameworks and individual limits to ensure that all aspects of the organisation's activities remain within this risk appetite. The guiding principles are:

1. We accept and tolerate our exposure to political risk¹¹ as a consequence of our mandate and our role in providing financial assistance to the benefit of ESM Members which are experiencing, or are threatened by, severe financing problems to safeguard the financial sustainability of the Euro area
2. We accept and tolerate credit risk in our financial assistance portfolio and regard this exposure as an implicit consequence of our role as a financial stability mechanism
 - a) We safeguard paid-in capital, and have the ability to call additional authorised unpaid capital to absorb losses resulting from default in this portfolio
 - b) We ensure that repayments due by the ESM beneficiaries under the stability support are received in a timely manner
3. Maintaining the highest creditworthiness in order to ensure continuous access to market funding is a prerequisite for performing our mandate and fulfilling our purpose
 - a) This is one primary objective of risk management activities within the ESM ▶

¹⁰ The minimum capital requirements are that the ESM must maintain a minimum 15% ratio between paid-in capital and the outstanding amount of ESM issuances, as specified in Article 41 of the ESM Treaty.

¹¹ Defined in the ESM Risk Policy as "the risk of losses arising as a result of a single or multiple political events that impact the ESM's ability to perform its mandate (e.g. by reducing access to the market for funding)"

- b) In support of this, paid-in capital is safeguarded and not used for on-lending; instead it is deployed as a part of a dedicated buffer to absorb losses arising from ESM operations, in accordance with Article 25 of the Treaty
 - c) We will ensure long term access to funding markets by considering and managing reputational as well as economic factors and recognise that managing reputational risk is crucial to our ability to effectively perform our mandate
4. Capital preservation is the central tenet of our investment activities
 - a) We will accrue capital through retained earnings from investments and the Pricing Policy, subject to the Treaty and the Dividend Policy, to enhance our ability to perform our mandate
 - b) Derivatives will only be used for risk management purposes to meet agreed statements of risk appetite
 5. We protect our creditors through strategies to mitigate Funding Liquidity Risk, ensuring our ability to honour due payments associated with our liabilities, even under stressed conditions
 6. Our investment and funding strategies are designed to minimise our exposure to Financial Risks, in line with the Investment Policy
 7. We recognise that exposure to operational risks and other non-financial risks is inevitable; we ensure that these risks are managed through adequate controls and appropriate monitoring and mitigation is in place for all material risks identified

In addition, internal statements have been drafted, defining the tolerance for specific material risks that the ESM itself can manage and mitigate. These provide targets for certain qualitative and quantitative measures relating to target rating, capital adequacy, liquidity, ALM and funding, financial and non-financial risks. These detailed provisions for risk appetite objectives have been designed to accord with other Board approved policies, such as the Investment Policy, and are overseen and monitored by the Board Risk Committee.

7.1.3. Risk Culture

The establishment of a strong risk culture is of paramount importance to the ESM. Risk culture is the combined set of individual and corporate values, attitudes, competencies and behaviours that determine the ESM's commitment to the management of risk at all levels.

Supported by the Managing Director and the Management Board, risk culture in the ESM is founded on a close alignment within the whole of the ESM in supporting the objectives of the risk management framework. Such a culture embeds and operationalises an independent discipline, which in turn ensures rigorous challenge and objectivity in decision-making.

7.1.4. Three Lines of Defence

Risk management is a shared responsibility of all parts of the organisation. The Three Lines of Defence concept, as established in the High Level Principles and expected by stakeholders as best practice, sets out the principles for ensuring the appropriate segregation of powers and duties, clearly drawn lines of authority and distinct roles and responsibilities for the management and control of risk.

First Line of Defence: Departments and business functions assume direct responsibility for the day-to-day management of risk. All staff are responsible for ensuring that risks relating to their operations are identified, followed up and reported to the Risk Department. Each of the First Line of Defence areas conducts its activities to meet the objectives of ESM in line with stated risk appetite, operates within the limits, policies and guidelines set by the Risk Department and other control functions (e.g. Compliance, Legal) and is responsible for the risks taken in performing its function. All other ESM staff have a direct responsibility for understanding and managing risk, and are subject to the ESM Code of Conduct. All staff are regarded as the First Line of Defence with respect to non-financial risks, particularly compliance and operational risks.

Second Line of Defence: This is principally an independent risk management function responsible for ensuring that risks assumed by the business are appropriately managed and controlled. It proposes mandates, guidelines, policies and limits to ensure risk-taking remains within the institution's risk appetite, as well as provide reporting and monitoring of the organisation's compliance with risk governance.

The Risk Department exercises independent central oversight of risk and ensures the comprehensiveness and consistent implementation of the risk management framework by all business functions. The ESM has also in certain cases sought to leverage risk assessment and monitoring skills across the organisation by means of embedding such capability in its front line teams, whilst still ensuring that the Risk Department is adequately resourced to provide robust oversight and control.

The head of the Risk Department ("Head of Risk") is a direct report to the Managing Director. The Head of Risk is responsible and accountable for informing the Managing Director on all risks to ensure enforcement and oversight. The Head of Risk has access to all information and decisions necessary to evaluate risk, and also

has direct access to the Board of Directors and the Board Risk Committee.

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

7.1.5. Risk Management

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

Risk identification is the process for ensuring the identification of all material risk exposures, both financial (Credit, Market and Liquidity Risk) and non-financial, faced by the ESM, together with relevant internal or external indicators that support proactive, forward-looking assessment of actual or potential changes in risk exposure.



Risk assessment is the process for assessing all identified risk exposures to determine their materiality. For financial risks, materiality is typically assessed on the basis of expert judgement and in consultation with relevant internal stakeholders. For non-financial risks this is done by assessing probability of occurrence and the consequences / impact to the organisation in the event of occurrence.

Risk monitoring is the set of processes, procedures, responsibilities and tools needed for on-going monitoring and reporting of material risk exposures and for triggering the active management of an unacceptable risk exposure. This requires robust, auditable control processes, limit frameworks, breach escalation mechanisms, dashboards, reports and other tools to ensure appropriate risk monitoring.

Certain financial risk exposures are monitored by setting appropriate limits on exposure. Credit Risk limits are set against individual obligors, such as issuers or derivatives counterparties in the case of the investment of ESM's capital. Market Risk limits are set against certain aggregated exposures such as portfolio duration, value at risk or the outcomes of stress tests. Liquidity Risk limits are set against certain funding outcomes and market indicators of liquidity.

Risk management is the process of determining and executing appropriate actions, typically by the Front Office, or the implementation of specific policies to actively manage risk exposures. For financial risks, these management actions, might include elimination, mitigation, transfer, reduction or acceptance of the risk.

7.2. Nature of ESM Activities and Key Risks

The ESM is a supranational, non-commercial entity, established to support the stability of the euro area and euro area Member States. Effectively fulfilling this mandate requires ensuring the highest creditworthiness in order to minimise the cost of borrowing to support lending operations and ensure market access. In order to attain the highest credit rating, overall risk tolerance and the Investment Policy are conservative in order to minimise the risk of capital loss, maintain access to the funding market and manage credit risk.

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

7.2.1. Credit Risk

Credit Risk is the potential for loss arising from inability of a counterparty to fulfil its contractual obligations for full value when due or at any time thereafter. The ESM is exposed to Credit Risk from two distinct and separate sources:

(1) Credit Risk from lending activities, namely Financial Assistance Default Risk, and (2) various forms of Credit Risk from investment and funding activities.

(1) Credit Risk from lending is the risk of loss due to the ESM lending to beneficiary Member States (i.e. to whom

stability support has been extended) should they not fulfil their contractual obligations with respect to the instruments used to provide financial assistance. Given the nature of its mandate, the ESM's Credit Risk from lending activities is a result of its activities performed in support of beneficiary Member States. The ESM is therefore exposed to Credit Risk through lending to these Member States. Where possible, the ESM will assess and mitigate this risk e.g. in agreeing an appropriate loan repayment schedule, nevertheless, the majority of the risk in the lending exposure has to be accepted.

As part of its early warning system, the ESM will monitor repayments and establish appropriate systems to ensure such monitoring is performed actively. The results of the early warning system are submitted to the Internal Risk Committee for review. The ESM has an established mechanism for drawing down callable capital if required (see the publicly available 'Terms and conditions of capital calls for ESM').

(2) There are three main types of credit risk faced in investing the ESM's paid-in capital and in conducting its funding operations:

- Issuer Risk – the risk of financial loss as a result of the non-fulfilment of its contractual obligations by the issuer of a debt instrument.
- Credit Concentration Risk – the potential for financial loss due to investments being too heavily concentrated in a particular issuer, class of issuer, sector, country or similar category, and therefore being exposed to the risk that Issuer Risk losses could be highly correlated with each other.
- Country Risk – the risk of loss brought about by the political, economic, legal, conventional or other characteristics inherent to the country or the risk of losses arising from changes in a country's situation due to a fall in predictability of governmental measures, economic downturn or social turmoil.

The ESM is exposed to these risks through its need to invest the tranches of paid-in capital and Liquidity Buffer. Exposure is managed by a set of independently approved counterparty and issuer limits, set according to a credit policy which takes into account concentrations. Further credit risk controls will be introduced, for example when the ESM uses derivatives.

7.2.2. Market Risk

Market Risk is the risk of losses arising from changes in the values of financial assets and liabilities (including off balance sheet items) due to fluctuations in market factors such as interest rates, foreign exchanges, prices of securities etc. Market Risk can be structural (in relation to assets and liabilities) or non-structural (in relation to investments). The ESM has both types of Market Risk: structural for the lending and funding activity, and non-structural in relation to the investment of the paid-in capital.

The main Market Risk that the ESM faces is Interest Rate Risk. This is the potential for loss arising from adverse movements in interest rates. This arises as the risk of loss due to adverse movements in market yields or the term structure of interest rates. There are different ways Interest Rate Risk can manifest itself:

Structural	<ul style="list-style-type: none"> • <u>General Interest Rate Risk</u> is the risk of loss due to an adverse change in the overall level of interest rates acting on the net level of interest rate exposure between assets and liabilities.
Non-Structural	<ul style="list-style-type: none"> • <u>Refinancing Risk</u> is the risk of loss of income arising from the differences in maturity profiles of the assets and liabilities (maturity mismatch or ALM risk) due to changes in the term structure of interest rates, i.e. steepening or flattening of the curve. Refinancing Risk occurs when the maturity of assets is longer the maturity of the liabilities used to fund them. Even though all funding costs arising from this risk are currently "passed through" to the Member States under financial assistance, as defined by the ESM Pricing Policy, the ESM measures and monitors this risk continually, since it is generally the case that long-dated assets will be funded by shorter-dated liabilities. • <u>General Interest Rate Risk</u> is the risk of loss due to an adverse change in the overall level of interest rates affecting the value of the investments. There will not be a realised profit or loss unless the investments are subsequently sold at the new interest rate level. • <u>Basis Risk</u> is the risk of loss due to an unexpected divergence in the spread between different sectors of the interest rate market used as the basis for pricing the investments, or between a derivative product and the exposure it is hedging.

Structural Interest Rate Risk is controlled by reference to cashflow projections performed by the ALM unit, leading to a requirement for available cash to repay maturing bills and bonds, supported by a short-term Liquidity Buffer as defined in policy. The ESM is required to maintain coverage of all outflows up to one year using the Liquidity Buffer and a set proportion of its capital.

Non-structural Interest Rate Risk is controlled by a series of limits on portfolio duration, monitored daily. There are also longer term value-at-risk limits for each tranche of the paid-in capital as described in the Investment Policy.

There are other Market Risks that the ESM has identified. Credit Spread Risk is the risk of loss on an investment in a debt security as a result of a decrease in the value of the security due to an actual or market implied decrease in the creditworthiness of the issuer. Spread risk can be specific to a particular issuer as well as being driven by changes in sector, country and other relevant spreads. This risk is controlled within the set of value-at-risk limits described above. Foreign Exchange Risk is the potential for loss arising from changes in the exchange rates. Since the ESM currently funds and invests only in the euro currency, this risk is not currently present. The ESM currently does not use derivative instruments in any of its activities.

7.2.3. Liquidity Risk

There are two main types of Liquidity Risk faced by the ESM:

- Funding Liquidity Risk is the risk of losses arising from difficulty in securing the necessary funding, or from a significantly higher cost of funding than normal levels, due to a deterioration of the ESM's creditworthiness, or at a time of unfavourable market conditions (e.g. periods of high stress)
- Liquidity Concentration Risk is the potential loss arising from concentrations in assets and liabilities as major sources of liquidity, particularly in times of market stress

Liquidity Risk is addressed by holding sufficient capital at all times, plus an adequate Liquidity Buffer to cover its short-term liquidity needs. The ESM continually monitors funding conditions, and stresses its projections of asset and liability cashflows based on a number of alternate assumptions. The ESM further minimises Liquidity Risk through a diversified funding strategy as prescribed in the Borrowing Guidelines.

Market Liquidity Risk is the potential for loss arising from a position that cannot easily be unwound or offset at short notice without significantly negatively influencing its market price due to inadequate market depth or market disruption. This risk is controlled by limits such as the total proportion of a bond issuance that can be held.

7.2.4. Non-Financial Risks

The ESM is subject to a number of non-financial risks due to the nature of its activities and its mandate, which include Operational Risk, Reputational Risk, Legal Risk, Compliance Risk and Political Risk. Careful vigilance in regard to all of these risks is a major priority for the ESM. Each is identified, assessed and monitored by the relevant department within the ESM, with periodic oversight provided by the Internal Risk Committee and Board Risk Committee.

Operational Risk is the potential loss and/or damage (such as the inability of the ESM to fulfil its mandate) resulting from inadequate or failed internal processes, people and systems or from external events. Categorisation of potential losses arising from Operational Risk events is based on guidance from the Basel Committee on Banking Supervision known as Basel II (2006), namely potential losses due to:

- Execution, delivery and process management
- Counterparts, products and business practices
- Internal and external fraud
- Business continuity and system failures
- Employment practices and workplace safety
- Damage to physical assets

Operational risk events are reported by all members of staff according to rules set by an internal operational risk policy. A central register of risks, events and associated losses is kept. Follow up of events takes place to establish causes and agree on mitigating actions. The ESM's risk appetite contains an extremely low tolerance for operational risk losses.

Reputational risk is the risk of loss and/or damage arising from a deterioration in the organisation's reputation, reducing its access to the market, lowering of credit rating, loss of political capital, inability to attract suitably qualified staff and other similar consequences.

Legal risk is the risk of loss as a result of inadequate or inefficient documentation, legal capacity, enforceability and applicability of national and international laws and litigation in the jurisdictions under which the ESM operates. Legal Risk also includes non-compliance with the Treaty establishing the ESM, associated by-laws or any other applicable laws and contractual obligations.

Compliance risk is the risk of loss and/or damage associated with the non-compliance with internal policies, procedures and guidelines as well as any external policies, regulations and directives which might govern the ESM. Compliance risk is associated with Legal Risk.

Political risk is defined as the risk of loss and/or damage arising as a result of a single or multiple political events that impact the ESM's ability to perform its mandate (e.g. by reducing access to the market for funding).

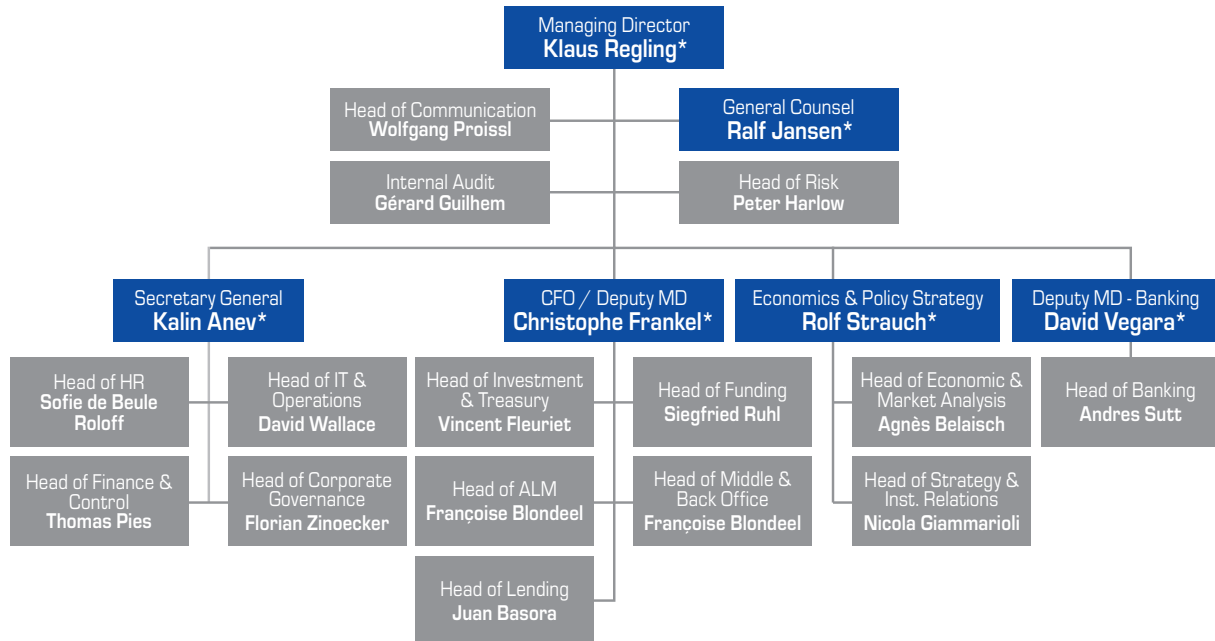


On the first of May
2013, the ESM had
a headcount of 85
staff members

..... Non-core functions
are **outsourced to**
external public and
..... private institutions

8. Organisation

ESM Organisational Structure (as of 31/12/2012)



*Member of ESM Management Board

8.1 Responsibilities of Departments

8.1.1. Finance

The Finance department is responsible for raising the funds to enable the ESM to fulfil its mission and to structure, negotiate and implement the Financial Assistance Facilities. It monitors and manages the structural risks (e.g. interest rate, liquidity) and performs the cash management function for the institution. The Department also ensures that all ESM financial transactions are being adequately booked, settled, controlled and reported and plays a front-end role in monitoring risks, including counterparty, settlement and operational. In addition, the Department manages the paid-in capital and implements its investment policy.

The Department is structured in five different areas: Lending, Funding and Investor Relations, ALM, Investment and Treasury, and Middle and Bank Office functions.

8.1.2. Banking

The Banking Department provides support in the design and implementation of financial assistance to financial institutions via their ESM Members in the context of an adjustment program ("indirect recapitalization"). It participates, where appropriate, in the design and implementation of banking-related aspects of financial assistance where such assistance is used to support financial institutions, monitors the banking sectors in the euro area, especially those in countries receiving financial assistance, and contributes to the evolving debate for banking crisis resolution and the so-called banking union.

8.1.3. Economics and Policy Strategy

The Economics and Policy Strategy Department (E&PS) develops, assesses and reviews the ESM's policy strategy, financial architecture and financial assistance instruments. It analyses the general macroeconomic environment with a focus on the euro area economies, specifically those countries in a financial assistance programme, and the functioning of the financial markets, specifically in relation to sovereign debt.

In addition, E&PS develops early warning systems on macroeconomic and credit risks in programme countries, develops and maintains credit risk assessment system for the ESM investment strategy and represents and coordinates the ESM's activity with euro area and international institutions.

8.1.4. Legal Department

The Legal Department provides expert legal support and legal documentation to the ESM and manages the legal risks arising from the ESM's unique mandate. It works closely with all ESM Departments in order to i) preserve the ESM's interests, ii) provide an effective contribution to the ESM strategy with respect to the integrity of the business, iii) mitigate legal risks that may result from the ESM business activities, and iv) provide legal advice with regard to the ESM activities and operations.

The Department also manages corporate legal structures and corporate aspects/matters, provides transaction support and is involved in the approval/review of new products.

8.1.5. Secretary General

The Secretary General Department provides key services to the ESM as well as to external stakeholders, its Board of Governors, Board of Directors, Board of Auditors, shareholders/MS, and other IFIs.

The department is organized in four divisions. Corporate Governance and Internal Policies supports the ESM's strategic goals through effective, integrated communications with both external and internal stakeholders and audiences and provides corporate functions to ensure organisational effectiveness such as Operational Risk, Procurement and Internal Processes and Policies. IT & Operations provides Information Technology services, infrastructure and facilities. Corporate Finance contributes to the development and maintenance of corporate finance policy, prepares reports and accounts, monitors and reports on the financial position and maintains effective controls. Finally, Human Resources ensures that the ESM is able to attract and retain quality staff and fosters an inspiring and motivating work environment.

8.1.6. Communication and Press

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



8.1.7. Risk

The Risk Department ensures that the agreed elements of the ESM's risk management framework are applied effectively to all aspects of its mandate. Its Head chairs and coordinates the Internal Risk Committee, which considers and decides upon any matters of evaluating, monitoring and approving practices regarding the implementation of the ESM Risk Management Framework and relating to risk management within its operations. It examines the overall risk profile and material risk developments, reviews the control environment, and assesses the effectiveness of the Framework.

8.2. ESM Staff

As of 1 May 2013, the ESM has a headcount of 85 staff members. In accordance to the budgetary approval by the Board of Directors, the ESM will grow to 120 staff members by the end of the year. The ESM staff consists of professionals, operational and support staff with backgrounds from both the public and private sectors. Currently, the majority of staff are employed on contracts between 2 and 5 years in length. Additionally, non-core functions are outsourced to external public and private institutions through service level agreements and other contractual arrangements.

8.3. Recruitment policy

The decision to create a new position is taken by the Management Board within the overall staff limit set by the Board of Directors. The hiring manager and Human Resources team arrange the interview process and ensure that each candidate is interviewed by at least two Management Board members before an offer of employment is made.

In evaluating candidates, the ESM takes every step necessary to ensure fair competition based on the relative merit of applicants. Additionally, the ESM aims to achieve a diverse workforce and ensure equal treatment, i.e. not to discriminate on the grounds of age, cultural, ethnic and racial background, family status, gender, nationality, physical ability, religion or sexual orientation; however the most critical hiring criteria are individual merit and suitability for the post.

8.4. Secondment/fellowship programme

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

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



Financial Statements

Financial Statements for the period from
8 October 2012 (date of inauguration) to 31 December 2012

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The financial statements have been audited by **independent external auditors** according to Article 29 of the Treaty

The external audit was overseen by the **Board of Auditors** as required under the By-laws and the Treaty

BALANCE SHEET

As at 31 December 2012

(in EUR'000)

	Notes	31.12.2012
ASSETS		
Cash in hand, balances with central banks and post office banks	5	7,675,815
Loans and advances to credit institutions	6	
(a) other loans and advances		16,501,514
		<u>16,501,514</u>
Loans and advances to euro area Member States	7	39,461,824
Debt securities including fixed-income securities	8	
(a) issued by public bodies		8,429,948
(b) issued by other borrowers		366,086
		<u>8,796,034</u>
Intangible assets	9	101
Tangible assets	10	3,050
Subscribed capital unpaid	15	620,000,000
Subscribed capital called but not paid	15	47,137,248
Prepayments and accrued income	11	123,909
Total assets		739,699,495
LIABILITIES		
Debts evidenced by certificates	12	
(a) debt securities in issue		39,461,824
		<u>39,461,824</u>
Other liabilities	13	18,867
Accruals and deferred income	14	199,754
Total liabilities		39,680,445
SHAREHOLDERS' EQUITY		
Subscribed capital	15	700,000,000
Revaluation reserve	8	19,548
Loss for the financial period		(498)
Total shareholders' equity		700,019,050
Total equity and liabilities		739,699,495

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

OFF-BALANCE SHEET

As at 31 December 2012

(in EUR'000)

	Notes	31.12.2012
OFF-BALANCE SHEET		
Commitments	20	
(a) undisbursed loans to euro area Member States		60,532,000
		<u>60,532,000</u>

The accompanying notes form an integral part of these Financial Statements

PROFIT AND LOSS ACCOUNT

For the period from 8 October 2012 (date of inauguration) to 31 December 2012

(in EUR'000)

	Notes	Period from 8 October 2012 to 31 December 2012
Interest receivable and similar income		
(a) on loans and advances to credit institutions		471
(b) on loans and advances to euro area Member States		12,649
(c) on debt securities including fixed-income securities		3,369
		16,489
Interest payable and similar charges		
(a) on debts issued		(4,417)
		(4,417)
Commissions receivable		258
Commissions payable		(289)
Net profit on financial operations		1,282
General administrative expenses		
(a) staff costs	16	(217)
- wages and salaries		(123)
- social security		(94)
of which relating to pension		(91)
(b) other administrative expenses	17	(13,558)
		(13,775)
Value adjustments in respect of intangible and tangible assets		(46)
Loss for the financial period		(498)

The accompanying notes form an integral part of these Financial Statements

STATEMENT OF CHANGES IN EQUITY

For the period from 8 October 2012 (date of inauguration) to 31 December 2012

(in EUR'000)

	Subscribed capital	Revaluation	Loss for the finan- cial period	Total
At 8 October 2012	-	-	-	-
Subscription of capital	700,000,000	-	-	700,000,000
Loss for the financial period	-	-	(498)	(498)
Revaluation reserve	-	19,548	-	19,548
At 31 December 2012	700,000,000	19,548	(498)	700,019,050

The accompanying notes form an integral part of these Financial Statements

STATEMENT OF CASH FLOWS

For the financial period ending 31 December 2012

(in EUR'000)

	Period from 8 October 2012 to 31 December 2012
Cash flows from operating activities:	
Loss for the period	(498)
<i>Adjustments for:</i>	
Value adjustments in respect of tangible and intangible assets	46
<i>Changes in:</i>	
Tangible assets	(3,197)
Accrued interests	(126,646)
Prepayments	(93)
Accruals and deferred income	(1,544)
Other liabilities	18,867
Interest received on	33,271
Up-front service fee received	197,340
Net cash provided by operating activities	117,546
Cash flows from investing activities	
Change in debt securities including fixed-income securities	(8,802,969)
Change in loans and advances to credit institutions	(16,501,514)
Net cash used in investing activities	(25,304,483)
Cash flows from financing activities	
Issuance of common stock	32,862,752
Net cash provided by financing activities	32,862,752
Net increase in cash and cash equivalents	7,675,815
Cash and cash equivalents at the beginning of the period	-
Cash and cash equivalents at the end of the period	7,675,815

The accompanying notes form an integral part of these Financial Statements



The main expenditures relate to the **setting-up process** of the organisation

Notes to the Financial Statements

1. General information

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

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

The present Financial Statements cover the period from 8 October 2012, the ESM's inauguration date, to 31 December 2012. On a proposal from the Management Board, the Board of Directors adopted the Financial Statements on 21 March 2013 and authorised their submission to the Board of Governors for approval at their meeting on 20 June 2013.

1.1. General overview of financial assistance programmes

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

- Grant financial assistance in the form of loans to an ESM Member in the framework of a macroeconomic adjustment programme;
- Purchase of bonds in the primary debt market and arrange operations on the secondary debt market in relation to the bonds of an ESM Member;
- Grant precautionary financial assistance to ESM Members in the form of credit lines;
- Provide financial assistance for the recapitalisation of financial institutions through loans to the governments of ESM Members.

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

The total cost of a loan to euro area Member States is an aggregate of several distinct elements and established in the ESM Pricing Policy:

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

- Commitment fee – the negative cost of carry and issuance costs, charged for the period from raising funds by the ESM until disbursement to the Beneficiary Member State or for the period from the refinancing of the relevant funding instrument until its maturity. The commitment fee will be applied ex-post on the basis of the negative carry actually incurred.
- Service fee – the source of general revenues and resources to cover the ESM's operational costs. The service fee has two components:
 - i. up-front service fee (50 bps) generally deducted from the drawn amount,
 - ii. annual service fee (0.5 bp) paid on the interest payment date.
- Margin – paid on the interest payment date. The margin charged differs across financial support instruments.
 - i. For loans granted, the margin is 10 bps;
 - ii. For primary market support facility, the margin is 10 bps;
 - iii. For secondary market support facility, the margin is 5 bps;
 - iv. For precautionary financial assistance granted, the margin is 35 bps;
 - v. For financial assistance provided to an ESM Member for the recapitalisation of its financial institutions, the margin is 30 bps.

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

1.3. The ESM's first disbursement of financial assistance to Spain

On 20 July 2012, the Eurogroup granted financial assistance to Spain for the recapitalisation of its banking sector following an official request made by the Spanish government. The assistance granted by the Eurogroup was designed to cover the estimated capital requirements along with an additional safety margin, amounting to EUR 100 billion. The loans would be provided to the Fondo de Reestructuración Ordenado Bancaria (FROB), the bank recapitalisation fund of the Spanish government, and then channelled to the financial institutions concerned.

On 3 December 2012, the Spanish government formally requested the disbursement of to EUR 39.5 billion of funds. On 5 December 2012, the ESM launched and priced notes, which were transferred to the FROB on 11 December 2012. This marks the first instance of financial assistance provided by the ESM.

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

The financial assistance is accompanied by policy conditionality focused on the banking sector. The conditionality consists of bank-specific measures, including in-depth bank restructuring plans in line with European Union ("EU") state aid rules and sector-wide structural reforms. Reforms concerning the governance, supervision and regulation of the financial sector will also be implemented. In parallel, Spain has to comply fully with its commitments and obligations under the Excessive Deficit Procedure and the recommendations to address macroeconomic imbalances within the framework of the European Semester.

2. Summary of significant accounting policies

The principal accounting policies applied in the preparation of these Financial Statements are set out below.

2.1. Basis of presentation

The accompanying Financial Statements are prepared and presented in accordance with the 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'). However the Financial Statements do not include any management report. The Entity prepares an Activity Report ("description of policies and activities") which is presented separately from the Financial Statements and its consistency with the Financial Statements is not audited.

The preparation of Financial Statements in conformity with the Directives requires the use of certain critical accounting estimates. It also requires management to exercise its judgment in the process of applying the Entity's accounting policies. Areas involving a higher degree of judgment or complexity, or areas where assumptions and estimations are significant to the Financial Statements are disclosed in note 2.3.

2.2. Basis of measurement

The accompanying Financial Statements are prepared on a historical cost basis, except for the loans and advances to Member States and the debts evidenced by certifi-

cates which are measured at amortised cost, and the paid-in capital and reserve fund investments which are measured at fair value with gains and losses being recognised in the revaluation reserve.

2.3. Use of estimates

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

2.3.1. Amortisation of the up-front service fee

As described in the note 1.2 concerning the overview of the pricing structure of the financial assistance programmes, the ESM is entitled to charge 50 bps of up-front service and 0.5 bps annual service fee to cover the ESM's operational cost. ESM recognises the up-front service fees over a seven year period, to reflect to the best the economy of the business and to match to the best the occurrences of the expenses aimed to cover.

2.4. Foreign currency translation

The ESM uses the euro (EUR), the single currency of the Member States participating in the third stage of Economic and Monetary Union, as the unit of measure for the capital accounts of Member States and for presenting its Financial Statements.

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

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

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

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

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

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

2.6. Debt securities including fixed-income securities

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

2.6.1. Paid-in capital and reserve fund investments

The provisions on the capital of the ESM are laid down in Chapter 3 of the Treaty. The initial aggregate nominal value of paid-in shares is EUR 80 billion. Moreover in accordance with Chapter 5 of the ESM Treaty, the net income generated by the ESM operations and the proceeds of the financial sanctions received from the ESM Members under the multilateral surveillance procedure, the excessive deficit procedure and the macro-economic imbalances procedure established under the Treaty on the Functioning of the European Union ("TFEU") are put aside in a reserve fund.

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

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

Short-term tranche

The tranche with the highest requirements on liquidity of investments is the Short-term tranche. The main objective of the Short-term tranche is to allow the ESM to face any temporary disbursement to cover any shortfall due to a non-payment by a beneficiary country. This tranche is invested in liquid investment instruments with a capital preservation objective at a one-year horizon, for a high level of confidence.

Medium/Long-term tranche

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

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

If such financial asset is determined to be impaired, the cumulative gain or loss previously recognised in the revaluation reserve is recognised in the profit and loss account. However, interest is calculated using the effective interest rate method, and foreign currency gains and losses are recognised in the profit and loss account.

2.6.2. Liquidity buffer investments

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

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

At the balance sheet date, the ESM has no investments in the liquidity buffer investments.

2.6.3. Determination of fair value

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

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

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

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

Transaction costs and premiums/discounts are amortised in the profit and loss account through Interest receivable and similar income. Interest incomes 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 presenting risks of non-recovery of all or part of their amounts. Value adjustments are accounted for in the profit and loss account as value adjustments in respect of loans and advances and are deducted from the appropriate asset items on the balance sheet.

2.8. Intangible assets

Intangible assets comprise purchased computer software. It is carried at cost less accumulated amortisation calculated on a straight-line basis over three years.

2.9. Tangible assets

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

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

- Permanent equipment, fixtures and fittings: 10 years
- Furniture: 5 years

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

2.10. Prepayments and accrued income

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

2.11. Debts evidenced by certificates

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

2.12. Provisions

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

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

2.13. Subscribed capital

The ESM's shareholders are the 17 euro area Member States. In accordance with Article 8 of the ESM Treaty, the initial authorised capital stock is EUR 700 billion, which is divided into seven million shares, having a nominal value of EUR 100 000 each. The initial authorised capital was subscribed by the shareholders according to the initial contribution key provided in the Article 11 and calculated in Annex I of the ESM Treaty. The authorised capital stock was divided into paid-in shares and callable shares, where the initial total aggregate nominal value of paid-in shares was EUR 80 billion.

The initial authorised capital stock of the ESM is recognised as Subscribed capital, while the callable shares as uncalled capital in the balance sheet. Amount of paid-in capital not yet paid by the shareholders are recognised as receivable, subscribed capital called but not paid, in the balance sheet on the signature date of the decision of the capital call.

2.14. Accruals and deferred income

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

2.15. Interest receivable and payable

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

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

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



The ESM follows a **prudent approach** to risk-taking in order to limit potential losses

2.16. Employee benefits

(a) Pension obligation

The Entity operates a defined contribution plan funded through payments to insurance companies.

A defined contribution plan is a pension plan under which the Entity pays fixed contributions. The Entity has no legal or constructive obligations to pay further contributions if the plan does not hold sufficient assets to pay all employees the benefits relating to employee service in the current and prior periods.

The contributions are recognised as employee benefit expense when they are due.

(b) Termination benefits

Upon termination of employment re-settlement allowance are payable when employment is terminated by the Entity before the normal retirement date, or whenever an employee accepts voluntary redundancy in exchange for these benefits. The payment of such benefit is subject of conditionality of several criteria.

Such termination benefits could not be reliably estimated. Therefore no provision was recognised as at 31 December 2012 as described in Note 16.

2.17. Taxation

As authorised by Article 36 of the ESM Treaty, within the scope of its official activities, the ESM, its assets, income, property and its operations and transactions, is exempt from all direct and indirect taxes.

3. Risk management

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

- Credit risk
- Market risk
- Liquidity and funding risk
- Operational risk

In view of the mitigants, described in note 4 about the exposure on loans and advances to euro area Member States, the inherent risk of non-payment of the beneficiary Member States is not managed by the risk function of the ESM. Consequently the risk management section of this note does not include any credit risk aspect of the loans and advances to euro area Member States.

3.1. Risk management organisation

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

The targeted risk appetite preserves the ESM's funding capacity, ensure the highest creditworthiness and avoid unexpected capital calls. The risk appetite accounts for the minimum capital requirements, leverage and return on paid capital and is described in the Risk Policy. The risk appetite is set in the form of a global risk budget quantifying the maximal tolerable potential loss over a defined time horizon with an agreed probability covering all financial and non-financial risks of the ESM, and covering both on- and if applicable off-balance sheet items. The risk profile is defined by a set of limits applicable to curtail all types of risks. The ESM does not aim to generate profit on financial support granted to beneficiary member states and does not provide incentives for speculative exposures of its investment portfolio.

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

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

The head of the Risk Management Department ("Head of Risk") is a direct report to the Managing Director. The Head of Risk is responsible and accountable for informing the Managing Director on all risks to ensure enforcement and oversight. The Managing Director, as Chairman of the Board of Directors, reports the enforcement and oversight related information to the Board of Directors.

To support the implementation of the ESM's risk policies, the Internal Risk Committee has been created. The Internal Risk Committee translates the risk appetite into the internal limit structure, which is described in the Risk Policy and approved by the Board of Directors. The Internal Risk Committee assists the Board of Directors in ensuring the adequacy of the ESM's internal limit structure and limit setting, and in providing recommendations on changes of the internal limit structure and provide rec-

ommendations on identification of relevant risks, and on the suitability of methods to monitor and manage them. The Internal Risk Committee conducts on a periodical basis a risk self-assessment and reports the result to the Managing Director and has authority to suggest to the Managing Director to undertake investigations on risk management (including outsourced activities) through either internal or external audit teams.

3.2. Credit risk

Counterparty risk is defined as the potential for loss arising from the inability of a counterparty to fulfil its contractual obligations for full value when due or at any time thereafter. Credit risk is considered a particular form of counterparty risk and derives from the investment of paid-in capital, placement of possible excess liquidity, and hedging operations.

The ESM applies elements of its High Level Principles for Risk Management, as defined by the Board of Directors and its Risk Policy to the provision of financial support to ESM Members to the extent that they do not cover counterparty risk. As such, financial assistance in line with the purpose of the ESM is granted to ESM Members experiencing severe financial problems, if indispensable to safeguard the financial stability of the euro area as a whole and of its Member States.

We also refer to note 4 where loans to euro area Member States are described.

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

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

In EUR'000	Maximum exposure
Cash in hand, balances with central banks and post office banks	7,675,815
Loans and advances to credit institutions	16,501,514
Debt securities including fixed-income securities	8,796,034
On balance sheet credit risk exposure	32,973,363
Off balance sheet items	-
Maximum credit risk exposure	32,973,363

3.2.2. Risk profile of counterparties

The following tables show the breakdown of the financial assets per credit rating. In respect of debt securities including fixed-income securities, the credit rating of the individual issuances are presented, while for the other financial assets the credit rating of the counterparty.

In EUR'000	Credit rating*	Clean carrying value as at 31.12.2012
Cash in hand, balances with central banks and post office banks	AAA	7,675,557
	AA+	258
Loans and advances to credit institutions	AA+	16,501,514
Debt securities including fixed-income securities	AAA	6,256,136
	AA+	2,539,898
Total		32,973,363

*Based on the worst rating provided by the three rating agencies (Moody's, Standard & Poor's, Fitch) presented based on the rating scale as used by Standard and Poor's

This table does not include the breakdown of the loans and advances to euro area Member States, as the inherent risk of non-payment of the beneficiary Member States is not managed by the risk function of the ESM, as described in note 3.

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

In respect of the debt securities including fixed-income securities, the ESM has an established investment policy which sets strict investment guidelines that focus on issuers with highest credit standing in euro and included a limit structure to mitigate the maximum exposure per counterparty.

3.3. Market risk

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

3.3.1. Interest rate risk

Interest rate risk is defined as potential for loss arising from adverse movements in interest rates. Main sources of interest rate risk include asset or liability repricing, triggered by covenants or market movements, yield curve shifts, asymmetrical payoff characteristics of instruments with embedded optionality, imperfect correlation in the adjustment of rates earned and paid, and changes in the funding or lending spread. This risk applies to the paid-in capital investments and may in the future be minimised using interest rate swap and forward rate agreements.

Structural interest rate risk is defined as the risk of a mismatch between assets and liabilities on the balance sheet. The current pricing policy for the ESM passes through the cost of funding to beneficiary member states. As at 31 December 2012 all the debt securities issued, and the loans and receivables granted to the programme countries were done on matched funding basis.

3.3.2. Currency risk

Concerning the foreign exchange risk, all the debt securities issued, and the loans and receivables granted to the programme countries as well the paid-in capital investments are denominated in euro. The Entity does not therefore face any currency risk.

3.4. Liquidity risk

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

Funding liquidity risk is defined as inability to raise money in a timely manner. Due to this, the ESM could be unable to settle obligations in a timely fashion and be held in breach of obligations. Funding liquidity risk shall be minimised by maintaining multiple credit lines and/or maintaining minimal balance levels between current assets and current liabilities.

Market liquidity risk is defined as the potential for loss arising from a position that cannot easily be unwound or offset at short notice without significantly negatively influencing the market price because of inadequate market depth or market disruption. Market liquidity risk shall be minimised by adopting adequate measurements that allow the timely detection of liquidity deteriorations.

Liquidity concentration risk is defined as the potential loss arising from concentrations in assets and liabilities as major sources of liquidity. A concentration in assets can

disrupt an institution's ability to generate cash in times of illiquidity or reduced market liquidity for certain asset classes. A liability concentration (or funding concentration) exists when the funding structure of the institution makes the ESM vulnerable to a single event or a single factor, such as a significant and sudden withdrawal of funds or inadequate access to new funding. Liquidity concentration risk shall be minimised by securing credit lines.

The table hereafter analyses the financial assets and liabilities and the shareholders' equity of the Entity by maturity on the basis of the period remaining between the balance sheet date and the contractual maturity date.

As at 31 December 2012	Less than three months	From 3 months to 1 year	From 1 to 5 years	More than 5 years	Total
ASSETS					
Cash in hand, balances with central banks and post office banks	7,675,815	-	-	-	7,675,815
Loans and advances to credit institutions	13,650,000	2,850,000	-	1,514	16,501,514
Loans and advances to euro area Member States	-	-	-	39,461,824	39,461,824
Debt securities including fixed-income securities	3,037	753,934	8,039,063	-	8,796,034
Prepayments and accrued income	123,909	-	-	-	123,909
Total financial assets	21,452,761	3,603,934	8,039,063	39,463,338	72,559,096
LIABILITIES					
Debt securities in issue	2,499,942	6,461,882	30,500,000	-	39,461,824
Other liabilities	18,867	-	-	-	18,867
Accruals and deferred income	199,754	-	-	-	199,754
Total financial liabilities	2,718,563	6,461,882	30,500,000	-	39,680,445
Shareholders' equity*	-	-	-	32,881,802	32,881,802
Total shareholders' equity**				32,881,802	32,881,802
Net of financial position	18,734,198	(2,857,948)	(22,460,937)	6,581,536	(3,151)

* Excluding subscribed capital unpaid and subscribed capital called but not paid

** The shareholder's equity has no defined maturity



All departments are responsible for proactive mitigation of operational risks and for the **robustness of the controls** in their processes

3.5. Operational risk

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

- Execution, delivery and process management;
- Beneficiary countries, products and business practices;
- Internal and external fraud;
- Business continuity and system failures;
- Employment practices and workplace safety;
- Damage to physical assets.

Management has no tolerance for material operational risks, including those originated through third party/vendor engagements, which may result in inability of the ESM to effectively fulfil its mandate, or in significant loss and/or reputational damage. All departments are responsible for proactive mitigation of operational risks and for the robustness of the controls in their processes. In case significant operational risks are identified, management with support from the Operational Risk Function performs a root-cause analysis and implements improvements in the underlying processes and the control environment in order to reduce the probability of re-occurrence.

The current operational risk framework of the ESM includes an agreed definition, categorisation and governance structure for operational risk. The framework is in process of further development by the Operational Risk Function with oversight and control by the Head of Risk, the Internal Risk Committee and the Board of Directors.

4. Loans to euro area Member States

In line with the Eurogroup decision of 9 July 2012 the financial assistance for the recapitalisation of financial institutions for Spain was provided via the European Financial Stability Mechanism (EFSF) until the ESM became available and then was transferred to the ESM without gaining seniority status.

From an investor's point of view, the capital structure and the capital calls address the risk arising from the non-payment of the beneficiary Member States. In accordance with Article 9 of the ESM Treaty, there are two different instances when a capital call can be made to cover losses or avert non-payment:

- i. A capital call under Article 9(2) of the ESM Treaty to replenish paid-in capital could happen for two reasons:
 - to cover a shortfall due to a non-payment by a beneficiary country and,
 - if losses occurring due to other factors which lead to the reduction in the countervalue of the paid-in capital below the threshold of 15% of the maximum lending volume of the ESM.The Managing Director would again make a proposal, this time to the Board of Directors, which would specify the losses incurred and the underlying reasons. Simple majority of the Board of Directors is required to agree to call in capital under these circumstances. If any ESM member fails to meet the required capital call, one or more revised increased capital calls would be made to all ESM Members by increasing the contribution rate of the remaining ESM Members on a pro-rata basis. When the ESM Member which failed to contribute settles its debt to the ESM, the excess capital is returned to the other ESM Members.

- ii. Finally, an emergency capital call under Article 9(3) of the ESM Treaty would be used for the acceleration of the paid-in capital during the ramp-up period to comply with the requested capital ratio and to avoid default of an ESM payment obligation to its creditors. The Managing Director would have the responsibility to make such a capital call to ESM shareholders if there were such a risk of default. As stated in the ESM

Treaty, the ESM shareholders have irrevocably and unconditionally undertaken to pay on demand such a capital within 7 days of receipt of the demand. However, if any ESM Member fails to meet the required capital call, the same procedure would apply as for capital calls to replenish paid-in capital. This mechanism provides the strongest possible assurance to ESM bondholders that they will always be serviced and repaid.

5. Cash in hand, balances with central banks and post office banks (in EUR'000)

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

	31.12.2012
Current account balances with central banks	7,675,557
Current account balances with other banks	258
Total cash in hand, balances with central banks and post office banks	7,675,815

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

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

	31.12.2012
Money market deposits	16,500,000
Lease guarantee deposit	1,514
Total cash	16,501,514

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

7. Loans to euro area Member States (in EUR'000)

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

	Nr. of loans	Nominal amount	Clean carrying value as at 31 December 2012
Loans under banking sector recapitalisations			
- to Spain	5	39,468,000	39,461,824
Total	5	39,468,000	39,461,824

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

Balance as at 8 October 2012	-
New disbursements	39,461,366
- to Spain	39,461,366
Premiums/discounts amortisation	458
Balance as at 31 December 2012	39,461,824

On 3 December 2012, the Spanish government formally requested the disbursement of EUR 39.5 billion of funds for the recapitalisation of Spain's banking sector. The funds were transferred in the form of ESM notes on 11 December 2012 to the Fondo de Reestructuración Ordenada Bancaria (FROB), the bank recapitalisation fund of the Spanish government. The FROB will use these notes for the recapitalisation of banks and asset manager companies participating in the bank restructuring.

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

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

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

As at 31 December 2012, the clean amortised cost of the paid-in capital investments was EUR'000 8,776,486, against a clean market value of EUR'000 8,796,034. The difference represents the unrealised gains and is recognised directly in the equity within the revaluation reserve.

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

9. Intangible assets (in EUR'000)

The following table shows the movements of the intangible assets for the period from 8 October 2012 to 31 December 2012:

	Software	Total intangible assets
Historical cost		
Balance as at 8 October 2012	-	-
Additions	107	107
Balance as at 31 December 2012	107	107
Accumulated amortisation		
Balance as at 8 October 2012	-	-
Amortisation	(6)	(6)
Balance as at 31 December 2012	(6)	(6)
Net book value		
Balance as at 31 December 2012	101	101
Balance as at 8 October 2012	-	-

10. Tangible assets (in EUR'000)

The following table shows the movements of the tangible assets for the period from 8 October 2012 to 31 December 2012:

	Furniture and equipments	Total tangible assets
Historical cost		
Balance as at 8 October 2012	-	-
Additions	3,090	3,090
Balance as at 31 December 2012	3,090	3,090
Accumulated depreciation		
Balance as at 8 October 2012	-	-
Depreciation	(40)	(40)
Balance as at 31 December 2012	(40)	(40)
Net book value		
Balance as at 31 December 2012	3,050	3,050
Balance as at 8 October 2012	-	-

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

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

	31.12.2012
Interest receivable on:	
- Debt securities including fixed-income securities	112,700
- Loans and advances to euro area Member States	10,646
- Loans and advances to credit institutions	471
Prepayments	92
Total accruals and deferred income	123,909

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

The table below discloses the details of debt securities in issue outstanding as at 31 December 2012, together with the coupon rates and due dates.

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

* Zero-coupon bond

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

	2012
Balance as at 8 October 2012	-
Issuance during the period	39,461,366
Premiums/discounts amortisation	458
Balance as at 31 December 2012	39,461,824

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

13. Other liabilities (in EUR'000)

As at 31 December 2012, the other liabilities are entirely composed of supplier's invoices which are not yet settled amounting to EUR'000 18,867, from which EUR'000 16,040 is against EFSF.

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

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

	31.12.2012
Interest payable on debts evidenced by certificates	3,958
Deferred income on up-front service fee	195,796
Total accruals and deferred income	199,754

As explained in 2.3.1., the amortisation of the up-front service fee is recognised in the profit and loss account on a linear basis under Interest receivable and similar income on loans to euro area Member States.

15. Subscribed capital (in EUR'000)

	Subscribed capital	Uncalled capital	Subscribed, called capital
At 8 October 2012			
Subscription to the authorised capital	700,000,000	- 700,000,000	-
Authorised capital calls	-	80,000,000	80,000,000
At 31 December 2012	700,000,000	- 620,000,000	80,000,000

The ESM's shareholders are the 17 euro area Member States. The contribution key for subscribing to the ESM authorised share capital is based on the key for subscription, by the national central banks of the ESM Members, of the European Central Bank's (ECB) capital. The authorised share capital is EUR 700 billion, divided into 7,000,000 shares, with a par value of EUR 100,000 each, and is split according to the contribution key. Out of the total authorised share capital, EUR 620 billion is uncalled. As at 31 December 2012, the called capital amounts to EUR 80 billion, out of which EUR 32.9 billion is paid.

ESM Shareholders	ESM Key (%)	Number of shares	Subscribed capital	Subscribed capital called and paid
Federal Republic of Germany	27.1464	1,900,248	190,024,800	8,686,848
French Republic	20.3859	1,427,013	142,701,300	6,523,488
Italian Republic	17.9137	1,253,959	125,395,900	5,732,384
Kingdom of Spain	11.9037	833,259	83,325,900	3,809,184
Kingdom of the Netherlands	5.7170	400,190	40,019,000	1,829,440
Kingdom of Belgium	3.4771	243,397	24,339,700	1,112,672
Hellenic Republic	2.8167	197,169	19,716,900	901,344
Republic of Austria	2.7834	194,838	19,483,800	890,688
Portuguese Republic	2.5092	175,644	17,564,400	802,944
Republic of Finland	1.7974	125,818	12,581,800	1,437,920
Ireland	1.5922	111,454	11,145,400	509,504
Slovak Republic	0.8240	57,680	5,768,000	263,680
Republic of Slovenia	0.4276	29,932	2,993,200	136,832
Grand Duchy of Luxembourg	0.2504	17,528	1,752,800	80,128
Republic of Cyprus	0.1962	13,734	1,373,400	62,784
Republic of Estonia	0.1860	13,020	1,302,000	59,520
Malta	0.0731	5,117	511,700	23,392
Total	100.0000	7,000,000	700,000,000	32,862,752

In accordance with Article 9 of the ESM Treaty, there are three different instances when a capital call can be made. A general capital call concerns payment of the initial capital and an increase of paid-in capital which could be necessary, for example, to raise the lending capacity. To initiate such a call, the Managing Director of the ESM, would make a proposal to the Board of Governors outlining the objective of such a call, the amounts and contributions for each shareholder and a proposed payment schedule. The Board of Governors, with mutual agreement, may call in authorised capital at any time.

Moreover as described in note 4, a capital call to replenish paid-in capital could happen to cover any losses in paid-in capital due to a non-payment by a beneficiary country and if losses occurring due to other factors which lead to the reduction in the countervalue of the paid-in capital below the threshold of 15% of the maximum lending volume of the ESM. Finally, an emergency capital call would be used for the acceleration of the paid-in capital during the ramp-up period to comply with the requested capital ratio and to avoid default of an ESM payment obligation to its creditors.

16. Staff costs

The current staff of the EFSF will also work for the ESM, while the transfer of staff from the EFSF to the ESM will be concluded in the first quarter of 2013.

At the balance sheet date the ESM has only one employee who is a Member of the Management Board. No financial benefits or incentives such as loans or credit lines have been granted to this employee other than those presented as staff costs.

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

17. Other administrative expenditures (in EUR'000)

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

	2012
Advisory services	7,586
IT services	2,142
Legal services	2,092
Rating agencies fees	1,528
Other services	210
Total administrative expenditures	13,558

18. Related - party transactions

Key Management

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

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

Transactions with shareholders

As disclosed in details in Note 7, the ESM granted loans to Spain which is also shareholder of the Entity.

Transactions with European Financial Stability Facility

The European Financial Stability Facility (EFSF) is a company which was agreed by the countries that share the euro on 9 May 2010 and incorporated in Luxembourg

under Luxembourgish law on 7 June 2010. The EFSF's objective is to preserve financial stability of Europe's monetary union by providing temporary financial assistance to euro area Member States if needed.

The EFSF has been created as a temporary institution. In accordance with its Articles of Association, the EFSF will be liquidated on the earliest date on which there are no longer loans outstanding to a euro area Member State and all Funding Instruments issued by EFSF and any reimbursement amounts due to Guarantors have been repaid in full. This means that after a transitional period in 2013, EFSF would not enter into any new programmes but will continue the management and repayment of any outstanding debt and will close down once all outstanding debt has been repaid.

External expenses occurred in relation of setting up and running the ESM were recharged by the EFSF together with other non-expense related items. The total amount of items recharged representing EUR 16.0 million which has not been paid yet at balance sheet date.



19. Audit fee (in EUR'000)

The total fees accrued are presented as follows:

	2012
Audit fees	30
Total Audit fees	30

20. Off-balance sheet items

As at 31 December 2012, the off-balance sheet items represent the undisbursed part of the EUR 100 billion financial assistance programme to Spain and amounting to EUR 60.5 billion. Any future disbursement is subject to conditionality of the Memorandum of Understanding attached to the Financial Assistance Facility Agreement.

21. Events after the reporting period

The ESM's second disbursement to Spain

On 5 February 2013, the ESM disbursed EUR 1.865 billion to Spain for the recapitalisation of the country's banking sector. The financial assistance has been initially financed by one initial funding instrument - a floating rate note. The assistance is used for the recapitalisation of the following banks: Banco Mare Nostrum, Banco Ceiss, Caja 3 and Liberbank.



Auditor's report

To the Board of Governors of European Stability Mechanism

We have audited the accompanying financial statements of European Stability Mechanism, which comprise the balance sheet as at 31 December 2012, the profit and loss account, the statement of changes in equity and the statement of cash flows for the period from 8 October 2012 (date of inauguration) to 31 December 2012 and a summary of significant accounting policies and other explanatory information.

Board of Directors' responsibility for the financial statements

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

Responsibility of the "Réviseur d'entreprises agréé"

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

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

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

Opinion

In our opinion, the financial statements give a true and fair view of the financial position of European Stability Mechanism as of 31 December 2012, and the results of its operations and its cash flows for the period from 8 October 2012 (date of inauguration) to 31 December 2012 in accordance with the general principles of the Directives.



PricewaterhouseCoopers,
Société coopérative
Luxembourg, 21 March 2013

Represented by
Pierre Krier



Board of Auditors Report on the Financial Statements

This Board of Auditors report on the financial statements is addressed to the Board of Governors in accordance with Article 23(2)(d) of the ESM By-Laws. It is delivered in respect of the financial statements of the European Stability Mechanism for the period from 8 October 2012 (date of inauguration) to 31 December 2012.

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

The Board of Auditors carries out independent audits of regularity, compliance, performance and risk management of the ESM, inspects the ESM accounts, and monitors and reviews the ESM's internal and external audit processes and results. Information on the audit work of the Board of Auditors, its audit findings, conclusions and recommendations for the period from 8 October 2012

(the date of inauguration) to 31 December 2012 are included in the annual report, which has been prepared in accordance with Article 24(6) of the ESM By-Laws and submitted to the Board of Governors.

Having examined the start up phase of the ESM, the Board of Auditors observes, as detailed in its annual report prepared in accordance with Article 24(6), that the institution is still evolving and faces considerable challenges and work in progress as regards establishing suitable internal, operational and managerial controls; and notes, to the best of its judgement, that no other material matters have come to its attention that would prevent it from recommending that the Board of Governors approve the ESM financial statements for the period from 8 October 2012 (date of inauguration) to 31 December 2012.

Luxembourg, 13 May 2013

The Board of Auditors

Mr Marc Gengler
nominated by the
Supreme Audit Institution of the
Grand Duchy of Luxembourg

Mr Jules Muis
upon the proposal
of the Chairperson

Mr Ulrich Graf
nominated by the
Supreme Audit Institution of the
Federal Republic of Germany



Mrs Katarína Kaszasová
upon the proposal of
the Chairperson

Mr Harald Noack
nominated by the
European Court of Auditors

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2012

Annual Report

European Stability Mechanism

European Stability Mechanism



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