The reform of the ESM

How and why the euro zone's rescue fund has become the latest battleground between Italy and the EU

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For about a month, from 15 November to 13 December 2019, **the Italian political debate has been nearly monopolized by the quarrel about the European Stability Mechanism** (ESM), a discussion that has forced European leaders to postpone until June 2020 the closing of a package of reforms whose completion was expected by the end of 2019.

The last-minute delay has for now shifted the attention of the media and the financial community **to a wealth of other dossiers the government led by Giuseppe Conte is grappling with**: from the vote of a Senate commission on Matteo Salvini (the leader of the League, Italy's main opposition party) for the case of **Nave Gregoretti** (on January 20), to **regional elections** in Emilia Romagna and Calabria (on January 26), to say nothing of the **referendums** to cut the number of lawmakers and to redesign the electoral law, the reform of the justice system, the tensions within the **5-Star Movement**, the revocation of the highway concession from **Atlantia**, the bailouts of **Alitalia** and **ILVA**.

The calming down of the tussle about the euro zone's rescue fund **allows for a more objective** and clear **exam of the issue**, **with the awareness that** -- given the many question marks surrounding Conte's cabinet -- **the incoming** six-month-long **European negotiation on the ESM might even be led by a new government**, despite the wish recently expressed by PM Conte to reach the end of the parliamentary term, in 2023.

ESM: Factbox

Legal structure
- Permanent inter-governmental institution under international law

Capital structure
- Subscribed capital: €704.80bn
- Paid-in capital: €80.55bn
- Callable capital: €624.25bn

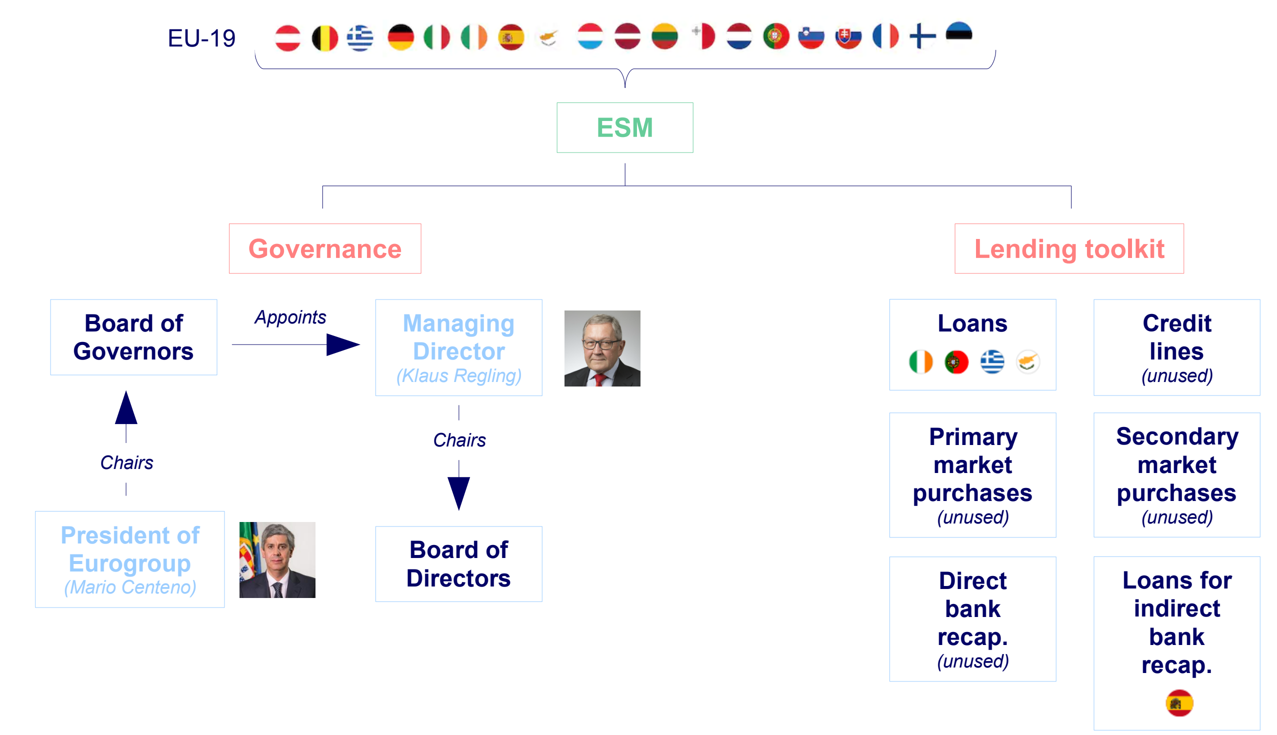
Lending capacity
- Maximum lending capacity: €500bn
- Outstanding loans: €89.9bn
- Available lending capacity: €410.1bn

Creditor status
- Preferred creditor (after IMF)

Rating
- Moody's: Aa1 (positive)
- Fitch: AAA (stable)
- DBRS: AAA (stable)

Source: ESM, Bloomberg

The European Stability Mechanism (ESM)



Source: European Stability Mechanism, Banca Promos

Visco's words

The controversy about the ESM, which for a few weeks at the end of 2019 has monopolized Italy's political debate, **has had a very precise inception: the words by Ignazio Visco** at the OMFIF-Bank of Italy seminar **on November 15**.

In the first part of his speech, **the Governor of the Bank of Italy expressed what, at first glance, sounded like a warning on the (back then) forthcoming approval of the overhaul of the euro zone's bailout fund**:

A reform of the Treaty on the European Stability Mechanism (ESM) to reinforce its role in preventing and managing sovereign crises in euro-area member states is currently being finalised. It is part of an effort aimed at reducing uncertainty as to how and when a sovereign debt can be restructured. Clarifying the conditions and procedures for restructuring would certainly reduce the part of the cost of a sovereign default which can be attributed to uncertainty over the manner and timing of its solution.

But this is only a small part of the cost of sovereign insolvency. Moreover, this is a matter to be handled with care. The small and uncertain benefits of a debt restructuring mechanism must be weighed against the huge risk that the mere announcement of its introduction may trigger a perverse spiral of expectations of default, which may prove to be self-fulfilling. We should all keep in mind the dire consequences of the announcement of private sector involvement in the resolution of the Greek crisis after the Deauville meeting in late 2010.

Visco's subsequent clarifications will prove useless: **the Pandora's box has been opened**.

10-year yields

Note: ESM, Germany, France, Italy

Source: Bloomberg

Timeline

June 7, 2010
EFSF is created

January 4, 2011
EFSF and Ireland sign Loan Facility Agreement

May 31, 2011
EFSF and Portugal sign Loan Facility Agreement

March 15, 2012
EFSF and Greece sign Master Financial Facility Agreement

October 8, 2012
ESM is inaugurated

November 29, 2012
ESM and Spain sign Financial Assistance Facility Agreement

May 8, 2013
ESM and Cyprus sign Loan Facility Agreement

December 8, 2013
End of Irish programme

December 31, 2013
Financial Assistance package for Spain ends

May 18, 2014
End of Portuguese programme

August 15, 2015
ESM and Greece sign Financial Assistance Facility Agreement

May 31, 2016
End of Cypriot programme

August 20, 2018
End of Greek programme

Source: European Stability Mechanism

The reform of the Treaty

Well before turning into a source of harsh, sometimes violent, political controversy inside and outside the Italian government, **the ESM has long been a subject of discussion within the main European institutions**.

Already two years ago, **in December 2017, the European Commission presented a package of measures** for the completion of the Economic and Monetary Union **which provided for the possibility of fully integrating the ESM into the institutional framework of the EU**, transforming it into the continental equivalent of the International Monetary Fund (IMF).

However, as negotiations progressed, it became increasingly clear that the proposal by the European cabinet was unable to gather the necessary support from member States. As a result, **in June 2019, an agreement was reached on less ambitious measures**, aimed at preserving the Mechanism's intergovernmental nature.

The completion of the reform process was expected by the end of 2019, but **the political controversy that emerged in Italy has forced European leaders to postpone a final agreement for another six months** (until June 2020).

PCCL/ECCL

One of the key elements under discussion with the reform of the ESM **concerns the simplification of the procedure to gain access to** one kind of credit line payable to troubled countries: **the Precautionary Conditioned Credit Line** (PCCL).

On the one hand, the criteria to comply with in order to receive financial assistance have been specified in greater detail; on the other hand, **conditionality has been limited to the need for signing a Letter of Intent** (LoI) **instead of a more binding Memorandum of Understanding** (MoU).

In detail, **the requesting State should**:

- **not to be involved into an Excessive Deficit Procedure** (EDP);
- **to have had**, in the two years preceding the request for financial assistance, **a deficit-to-GDP ratio lower than 3%**, a structural budget balance equal to or greater than the country-specific minimum reference value, **a debt-to-GDP ratio of less than 60%** or decreasing by 1/20 per year;
- **not to highlight excessive imbalances** in the context of the EU macroeconomic surveillance;
- **to show** historical **evidence of access to** international **capital markets** at reasonable terms;
- **to show a sustainable foreign position**;
- **not to highlight serious weaknesses in the financial sector** capable of endangering financial stability.

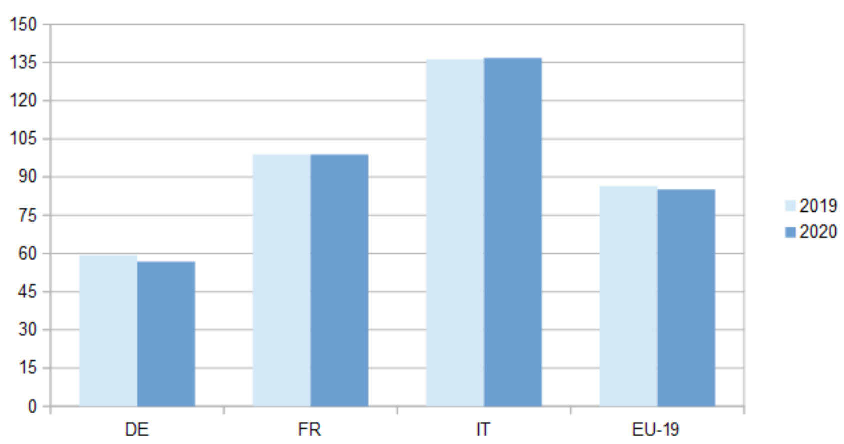
For all States that do not comply with the aforementioned criteria, a second type of credit line would remain available (the Enhanced Conditions Credit Line, ECCL), provided that their public debt is still considered sustainable and they agree to sign a MoU.

Fabio Panetta
Member of the ECB
Executive Board

"If I were to lead talks on ESM, I'd try to get something in exchange. For instance, on banking union, if there is anything that is not good for us in it, or to nominate one of our economists to lead the ESM."

November 23, 2019

Euro zone: debt-to-GDP ratio (%)



Source: European Commission, autumn economic forecast (Nov. 2019)

CACs

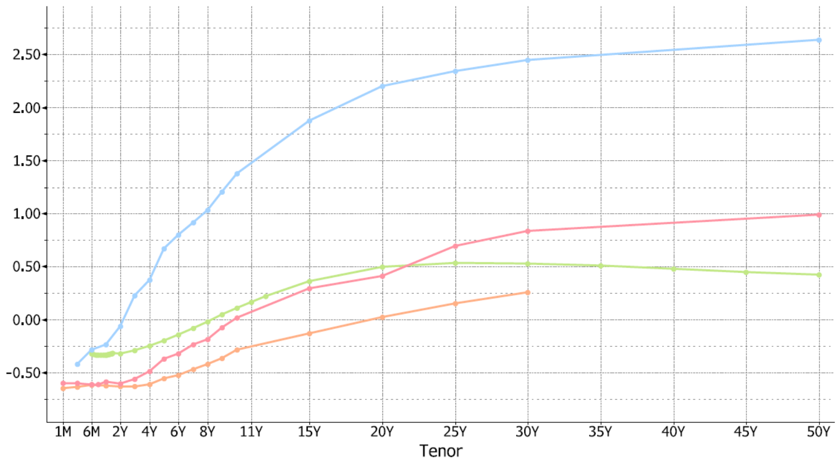
The inclusion of Collective Action Clauses (CACs) in the Terms and Conditions of euro zone's government bonds is nothing new.

Indeed, **as of 1 January 2013**, **all the bonds issued by euro area countries with a maturity greater than one year include dual-limb CACs** that require two distinct votes to bring changes to the terms of the notes, as part of a debt restructuring process: one at the level of each issue (equal to 75% or 50% of the outstanding, respectively in the case of a physical meeting or a written procedure) and one for the series as a whole (with the same percentages described above).

The reform provides that **starting from 1 January 2022, dual-limb clauses will be replaced** (as for newly issued securities) **with single-limb CACs**, that is clauses providing for a single-majority voting process.

The change aims at simplifying debt restructuring procedures, allowing bondholders to take a single decision for all the series of a given security, without the need to vote for each individual issue.

Yield curves



Note: Euro Swaps, Germany, France, Italy

Source: Bloomberg

Nicola Giammarioli
ESM Secretary General

The debate around the ESM in Italy "has more to do with the political aspect than with the real elements of the reform," but "it is good" that "politicians and parliaments discuss, it is the salt of democracy, it has happened in other countries in recent months, actually Italy comes late."

December 9, 2019

Debt sustainability

The prior assessment of debt sustainability for the purpose of receiving any form of assistance from the ESM **has been part of the Treaty since 2012 and will remain following the reform**. In addition, **the new version of the Treaty will introduce the assessment of the** requesting country's **loan repayment capacity**.

The proposal for reform foresees that **these two assessments will be conducted by the ESM together with the European Commission** (and the ECB) **on a transparent and predictable basis**, while **leaving a sufficient margin of discretion**.

If these institutions fail to reach a common opinion, the Commission will have the last word on debt sustainability and the ESM will have the last word on the capacity to repay the loan.

The agreement reaffirms the Commission's exclusive responsibility for the overall assessment of the economic situation of member countries and of their position in relation to the rules of the Stability and Growth Pact (SGP) and of the Macroeconomic Imbalance Procedure (MIP).

As for the possibility of a debt restructuring, **both the current Treaty and the reform proposal** do not envisage any automatism and **allows for private sector involvement only in exceptional circumstances**.

FOCUS: ESM mechanics

The European Stability Mechanism (ESM) **is an international organization established following the ratification of an ad-hoc intergovernmental treaty** (placed outside the EU legal framework but still included in the framework of public international law), signed on 2 February 2012 and set up on 8 October 2012.

The raison d'être of the ESM is the provision of financial assistance to euro zone countries which, despite having a sustainable public debt, have temporarily lost access to the bond market, due to a momentary lack of confidence by their creditors.

As suggested by its name, the goal of the ESM is to safeguard the stability of the currency bloc. **The assistance of the fund is provided in compliance with the principles of conditionality** (the intervention is never non-repayable and envisages both ex-ante and ex-post monitoring) **and proportionality** (the conditions are commensurate with the type of support received).

All 19 euro area countries have joined the ESM, and membership is also open to other EU member States. The organization is headquartered in Luxembourg and employs a staff of approximately 190.

Capital

Each member country holds a share of the ESM's equity capital calculated on the basis of the ECB's capital key, so as to reflect its weight on the total population and GDP of the euro area. This non-risk-based capital structure implies, for instance, that the virtually safest member country (Germany) is also the main shareholder of the fund (with a stake above 1/4 of the overall capital).

The ESM has a subscribed capital of €704.8bn, of which €80.5bn has been actually paid-in (about 11% of the total). The remaining €624.3bn can be recalled at any time in case of need.

The paid-in capital of the fund cannot be used to grant loans and is therefore invested carefully with the aim of preserving its value (and protect the creditworthiness of the organization).

Consequently, the ESM obtains the resources it needs to grant its loans through the issuance of money market and medium- to long-term debt instruments (in euros and US dollars, with maturities from 1 month to 45 years). As of today, **the euro-denominated bonds issued by the ESM are the security that resembles the most the never-created Eurobonds** (a safe asset representative of the entire single currency area).

An interest rate given by the sum of a 'base rate' (which reflects the extremely low cost of funding tapped by the ESM on the market), plus a 'service fee', a 'commitment fee' and an appropriate margin, **is applied to the loans granted by the fund**. Overall, this is a remuneration **lower than that required by private investors**.

Any profit deriving from this 'financial intermediation' activity can be distributed to shareholders in the form of dividends.

Governance

The Board of Governors is the highest decision-making body of the ESM and is made up of the ministers of Finance from the 19 euro area member States. The Board meets at least once a year (to approve the annual report) and whenever the affairs of the fund so require.

ESM lending for the Spanish banking sector

From - To: Nov 2012 - Dec 2013

Agreed: €41.3bn

Disbursed: €41.3bn

Repaid: €17.6bn

Source: ESM, European Parliament

The BoG can be chaired either by the president of the Eurogroup (as it is currently the case, being led by the Portuguese Mario Centeno) or can elect a president from among its members, with a two-year (renewable) mandate.

The executive body of the ESM is the Board of Directors, made up of 19 experienced officers, appointed by the governors from among people of high competence in economic and financial matters. The BoD takes decisions as provided for in the ESM Treaty and By-Law or as delegated by the Board of Governors.

The BoD is chaired by the Managing Director -- since the inception of the ESM, the German Klaus Regling -- who is the legal representative of the fund, manages its current affairs, and participates to the meetings of the Board of Governors. The MD is appointed by the BoG for a five-year term (renewable once). **Klaus Regling's second term will end in October 2022**.

Decision making

The voting rights of the members of the Board of Governors are proportional to the percentage of shares assigned to thier own countries. **Decisions about the granting of financial assistance** and the approval of MoUs **are taken unanimously**, without taking into account potential abstensions.

The quorum can be lowered to 85% of the capital if the European Commission and the ECB require urgent decisions to be taken, that is, in extraordinary circumstances where the financial and economic stability of the euro area appears to be threatened. **In such cases, Germany, France and Italy** (each holder of a share of voting rights greater than 15%) **have a veto power**.

Finally, **the appointment of the Managing Director, requires an 80% majority**, which implies that only Germany and France can veto the name of Klaus Regling's successor, being the only two shareholders of the ESM with an individual stake higher than 20% of the capital.

Tools

The ESM can use several instruments to respond to requests for financial assistance coming from its member States:

- **Loans**, as part of a macroeconomic adjustment programme;
- **Precautionary Conditioned Credit Lines** (PCCLs) and **Enhanced Conditions Credit Lines** (ECCLs);
- Primary and secondary market **sovereign bond purchases**;
- **Direct bank recapitalisation** and loans for **indirect bank recapitalisation**.

To date, **the first instrument has been used by Cyprus** (2013) **and Greece** (2015), **while Spain has made use of the indirect bank recapitalization tool** (2012). The remaining instruments are unused so far. Ireland, Portugal and Greece also benefited from EFSF funding (an 'ancestor' of the ESM, which still exists but is not authorized to grant new loans).

Currently, the ESM has outstanding loans for €89.9bn, of which €59.9bn towards Greece, €23.7bn for the recapitalization of Spanish banks and €6.3bn towards Cyprus. Given its maximum lending capacity of €500bn, the ESM has a residual lending capacity of €410.1bn.

ESM lending to Cyprus

From - To: Apr 2013 - Mar 2016

Agreed: €9bn

Disbursed: €6.3bn

Repaid: €0bn

Source: ESM, European Parliament

ESM lending to Greece

From - To: Aug 2015 - Aug 2018

Agreed: €86bn

Disbursed: €61.9bn

Repaid: €2bn

Source: ESM, European Parliament

The (official) stance of Italy's government

Setting aside the wide range of political opinions existing within the ruling coalition -- with the Democratic Party substantially in favor of the proposed reform and the 5-Star Movement more critical and divided on the issue -- **the official stance of the Italian government on the ESM has been expressed** in the institutional seats **by the Prime Minister, Giuseppe Conte, and by the minister of Economy and Finance, Roberto Gualtieri**.

Italians at the ESM

Roberto Gualtieri
Member of the Board of Governorns
(Minister of Economy and Finance)

Alessandro Rivera
Member of the Board of Directors
(Director General of the Treasury)

Nicola Giammarioli
ESM Secretary General

Source: European Stability Mechanism

Gualtieri has discussed the issue on November 27 during a hearing at the Finance and EU Affairs Commissions of the Senate. Previously, the minister had already issued a statement on the topic, published on the website of the Ministry on November 20.

According to Gualtieri, the Italian debate on the ESM has been extremely confused, especially in light of the fact that the reform does not introduce any substantial change to the existing framework. It is true that some countries (especially from Northern Europe) have asked, at the beginning of the negotiation, to make debt restructuring a condition for financial assistance, but **the final version of the reform does not provide for any automatism**. Indeed, the assessment of debt sustainability has always existed and the conditions to obtain ESM loans have not changed.

Even the introduction of single-limb clauses is a change that, according to the minister, **will have no impact on the public debt** of euro area countries, given that their aim is to prevent opportunistic and blackmailing behaviors by speculative investors.

In his statement, **Gualtieri has reassured** about the sustainability of Italy's public debt, reiterating **that Italy** has never requested and **will not ask for ESM loans**.

For his part, PM Conte has spoken about the euro zone's rescue fund in Parliament, first during an urgent report to the Upper and Lower Houses on December 2 and then, nine days later, during his communications ahead of the European Council of December 12 and 13.

Conte's statements have broadly echoed those by Gualtieri: no substantial changes to the Treaty, no automatic debt restructuring, package approach, full sustainability of the Italian public debt.

In addition, Conte has emphasized how the confused political debate already mentioned by Gualtieri **could insinuate doubts**, among international financial institutions, **on Italy's actual ability to maintain its debt on a sustainable path**.

Economists' opinions

The debate on the bailout fund has not been confined to the political statements by Italy's government and its opposition, but **has actively involved some of the country's most renowed economists**, almost always with expressions of support to the ESM but with some doubts about its proposed reform.

The former chief economist of Confindustria, **Giampaolo Galli**, has raised some worries during a hearing ahead of the Commissions V and XIV of Italy's Chamber of Deputies. While arguing that the ESM is a useful institution (acting as lender of last resort for all euro zone States), Galli has identified five main concerns (private sector involvement, overlap of powers between the ESM and the European Commission, assessment from the perspective of a lender, prior restructuring of unsustainable debts, single-limb CACs) and a key risk: that the idea of using market mechanisms to incentivize sound fiscal policies may have unintended consequences, turning temporary liquidity crises into actual defaults, through a vicious cycle of self-fulfilling expectations.

A specific aspect of the overhaul, the review of collective action clauses, has drawn **Maria Cannata**'s attention. According to the former director of the debt department of Italy's Treasury, the introduction of single-limb CACs within the context of a highly disrupted government bond market such as that of the second half of 2018, could have actually sent a counterproductive signal, being perceived as the premise of an imminent problem. But today, the market environment has changed and in the eyes of investors the update of CACs is almost irrelevant.

Maria Cannata's viewpoint is broadly shared by **Angelo Baglioni** and **Massimo Bordignon** in their joint op-ed hosted by lavoce.info. Indeed, according to the two economists, the new single-limb CACs will receive from the markets the same essentially indifferent welcome received by dual-limb CACs in 2013. The fear that the ESM, due to its intergovernmental nature, could express stricter assessments than those (mainly political) of the European Commission towards the countries requesting assistance is misplaced too, given that the Board of Governors of the ESM is ultimately made up of the Finance ministers of euro area countries.

The opinion of **Carlo Cottarelli** is a bit more worried. In two articles published on La Stampa, the former IMF official has expressed the fear that the changes made to the ESM, although not huge, could still signal to the financial markets a greater propensity toward debt restructuring than the current framework, in particular because the text of the Treaty does not make it sufficiently clear that restructuring should be an extreme tool and not an instrument among others to reduce public debt.

The Director of the Observatory on Italy's Public Accounts also stresses that one of the main advantages of a restructuring -- making creditors, instead of taxpayers, pay for the strengthening of public finances -- would be pretty limited in the case of Italy, given that about 70% of its debt is held by domestic investors. However, the actual problem of the country is another one: its public debt is too high and it is increasingly widespread internationally the idea that the only way to reduce it is not a gradual adjustment but a clean cut.

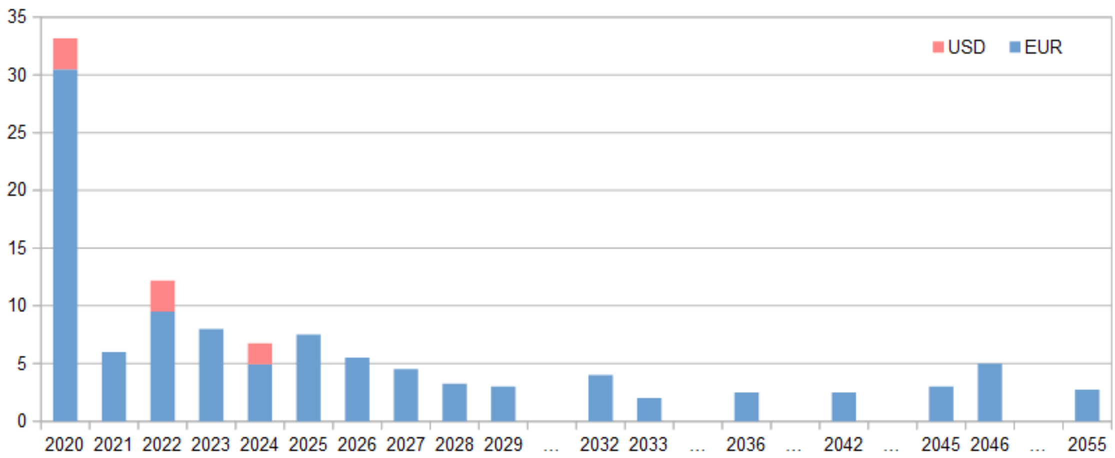
Definitely more critical are the tones of the **appeal signed by a group of 32 economists** and published by MicroMega on December 4. According to the authors, Italy should not sign the reform of the ESM because the rescue fund is a de-facto useless institution: Italy doesn't need it and resorting to it would only worsen its situation.

ESM subscribed capital

Country	Key (%)	€ bn
Germany	26.95	189.9
France	20.24	142.6
Italy	17.78	125.3
Spain	11.82	83.3
Netherlands	5.68	40.0
Belgium	3.45	24.3
Greece	2.80	19.7
Austria	2.76	19.5
Portugal	2.49	17.6
Finland	1.78	12.6
Ireland	1.58	11.1
Slovakia	0.82	5.8
Slovenia	0.47	3.3
Lithuania	0.41	2.9
Latvia	0.28	1.9
Luxembourg	0.25	1.8
Cyprus	0.20	1.4
Estonia	0.19	1.3
Malta	0.07	0.5
Total	100.00	704.8

Source: European Stability Mechanism

ESM: debt distribution (€bn)



Source: Bloomberg

From the ESM to the Banking Union

There's **a part of the reform of the ESM** which does not **concern** the assistance that the Mechanism can provide to financially troubled member States, but instead **the support it can give to the Single Resolution Fund** (SRF) within the framework of the European banking crisis management system.

The SRF, financed by contributions from the banking sector and managed by the Single Resolution Board (SRB), may deplete its resources **should it face a systemic crisis**. Accordingly, the ESM could provide it with a backstop, in the form of a revolving credit line.

This provision fully **integrates the ESM within the framework of the Single Resolution Mechanism** (SRM) -- the second pillar of the Banking Union, alongside the Single Supervisory Mechanism (SSM) and the still-unfulfilled European Deposit Insurance Scheme (EDIS) -- **and justifies the line of the Italian government, which argues that the proposal for reform of the ESM should be assessed as part of a wider package of interventions** (indeed, a position embraced by the Eurogroup on 13 June 2019).

Consequently, **the debate on the ESM is intertwined with the long-standing contention between those European governments that consider reducing bank risks as a priority** -- pushing for the introduction of concentration limits and risk weights for government bonds held by lenders -- **and those who consider risk-sharing to be the priority** -- with the creation of a common deposit insurance scheme, the launch of an euro-denominated safe asset and (as for risk reduction) the definition of stricter rules for Level 2 and Level 3 assets (complex, opaque and illiquid financial instruments considered, in particular by the Bank of Italy, as the Northern-Europe equivalent of Mediterranean lenders' Non Performing Loans).

In any case, **behind the** (almost exclusively Italian) **controversy arised around the ESM, a more fundamental theme remains, highlighted** precisely **by** the man who, perhaps involuntarily, triggered the heated dispute, Governor **Ignazio Visco**:

[A] country with high public debt, especially a country with great economic weight in the euro area, must first of all create a situation in which there is no need to turn to the ESM; how to obtain funding is not irrelevant but should not be the focal point. The way forward is to reduce the debt-to-GDP ratio by maintaining an adequate primary surplus, increasing economic growth, and keeping confidence high and the average cost of debt low.

Christine Lagarde
ECB President

"If we had had the ESM in full place, including the collective action clause and the debt restructuring mechanism, if we had had that in place at the very early days in the Greek crisis, I think collectively we would've been much more capable of resolving the issue in a more expedited manner."

December 12, 2019

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