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ESM Borrowing Guidelines

These guidelines outline the main elements of the ESM borrowing activity. The purpose of ESM is to mobilise funding and provide stability support under strict conditionality to the benefit of ESM Members. For this purpose ESM shall be entitled to raise funds by issuing financial instruments or by entering into financial or other agreements or arrangements with ESM members, financial institutions or other third parties. More specifically it is empowered to borrow on the capital markets from banks, financial institutions or other persons or institutions according to Article 21(1) of the ESM Treaty.

1 Funding objective and principles

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.

Second, the demand for ESM financing over time is highly variable. The instruments available to ESM may imply that large amounts of financing may be required at relatively short notice. Standard macro-economic adjustment programmes more often entail a relatively steady flow of limited amounts, though with uncertain disbursement profiles. The ESM borrowing strategy has therefore to offer the flexibility to raise predictable amounts over a longer period of time covering varying disbursement schedules as well as unexpected amounts on relative short notice, including prior to the entry into a financing programme.

Third, ESM shall engage in efficient funding in order to offer financing at reasonable conditions to the beneficiary ESM Members, with a priority given to mitigation of first liquidity risk and second appropriate balance between costs and interest rate risk.

With a view to these objectives, ESM has to establish itself in the market as a reliable issuer. In difficult market environments investors prefer to buy liquid products with an easy, plain vanilla structure. The ESMs basic portfolio of funding instruments shall fulfill these criteria.

The basic portfolio may be broadened to tap other segments of the capital market when required due to specific financing needs and schedules.

Moreover, ESM shall aim to access different parts of the money market to manage liquidity risk.

Finally, ESM can use derivative instruments, whenever appropriate, to manage the interest rate risk or other risks like currency risk.

2. Funding tools

A broad portfolio of funding instruments is needed to ensure the necessary flexibility to issue large amounts on short notice. This portfolio of funding and pre-funding instruments should include capital market instruments and money market instruments to deliver the required flexibility.

2.1 Capital Market Instruments

<u>Bond Programme:</u>

ESM shall establish a Euro denominated debt issuance programme. This programme will be the main framework to issue medium and long term bonds.

ESM may launch benchmark transactions throughout maturities from 1yr until 30yr. The strategy of building such a curve with different benchmark lines offers access to different types of investors and allows raising large amounts of funding. Increasing the size of some outstanding lines in order to provide more liquidity to investors can be envisaged as an element to strengthen the funding efficiency.

The issuing processes will be flexible with syndicated transactions as well as auctions. In addition to the regular benchmark transactions and increases of outstanding lines, the ESM can issue bonds as private placements. This additional flexibility will help the ESM to improve its overall funding cost and take advantage of the specific demand which may arise from large investors.

ESM retains the flexibility of holding own bonds for a limited amount. This offers the possibility to raise additional funding either by selling the bonds in the secondary market or by using them as collateral in the secured money market. It also helps testing real demand from market participants to secure the success of taps or auctions.

<u>Other capital market instruments:</u>

- As a complement to the Bond Programme, the ESM can issue promissory/registered notes. This instrument allows taking advantage of a substantial additional demand in this kind of specific products, and may be valuable when large or unexpected financing needs arise.

- From time to time ESM can further diversify its funding strategy by issuing in other currencies. Such foreign currency issues shall be hedged through swap contracts.

ESM may enter swaps contracts allowing ESM to hedge interest rate and currency risk exposure.

2.2 Money Market Instruments

- ESM shall establish a bill programme through regular auctions. Such a programme will allow ESM to raise large amounts even in volatile environment. It gives flexibility and efficiency as bond issues can be launched when market conditions are adequate.

- ESM can engage in unsecured money market transactions. Transactions can be done same day, on a rolling basis or for tenors up to one year. This flexible instrument can be used to finance temporary liquidity gaps.

- ESM shall establish liquidity lines with DMOs of ESM Members. The amounts available from individual DMOs to lend to ESM have to be in accordance with national budget law rules and the cash position of the respective office. Therefore, these lines should be used in exceptional circumstances only, when other ways of funding are not available.

- ESM shall establish a network of credit lines with private banks. These credit lines shall be used to bridge temporary short term liquidity gaps.

- ESM may use other money market instruments, such as commercial papers denominated in euro or, if needed in other currencies, money market promissory notes, and engage in repo transaction.

ESM would be entitled to start its borrowing activities in line with the limits set out on the liquidity buffer and the overall borrowing amounts upon approval of these guidelines.

3. Transfers of the raised funding amounts into loans

Under a matched funding approach, funding instruments and the loan have mostly the same financial profile as regards the amount, time of issue, currency, repayment profile, final maturity and interest index.

Under a diversified funding strategy, the characteristics of the funding instruments are extended to a wide range of techniques and can deviate from the parameters of the loan. A variety of instruments, maturities and, where deemed appropriate currencies can be used to ensure the efficiency of funding and continuous market access. As a consequence, liquidity, interest rate or currency exposure could arise and management of those risks to minimize the exposure of ESM will be necessary. ESM shall be entitled to adopt a diversified funding strategy to be able to fulfil its purpose as stated in Article 3 of the Treaty establishing the ESM in the most efficient and flexible way. The diversified funding strategy will be based on a short-term and a medium-to long-term funding pool.

The aggregate size of the short-term and medium-to-long-term funding pools will be of an amount equal to, or somewhat higher than, the aggregate of the facilities outstanding.

The size of the liquidity buffer is approved by the Board of Directors.

The implementation of a diversified funding strategy shall be based on an appropriate risk management framework as specified in the high level principles and the risk policy.

4. Governing law and Clearing Systems

The documentation of the ESM debt issuance programme (DIP) will be governed by Luxembourg law or by any other major law if required for specific instruments or investors. DIP in currencies other than the EURO will be approved by the Board of Directors.

Clearing will be performed by the major platforms.

For an interim period, the ESM DIP may be carried out based on a similar legal structure as the EFSF DIP whose operating model requires a clearing settlement in Frankfurt.

5. Reporting and procedures

The implementation of the borrowing strategy shall be in accordance with the provisions of the Treaty and the ESM by-laws.

In addition, these guidelines shall be implemented through a set of internal procedures specifying the authorizations, delegations and controls for the steps to be taken ahead and after a transaction. In particular, they shall detail the involvement of the Middle Office and the Head of Risk in controlling risks in line with the risk management framework.

The Managing Director shall report regularly, at least every three month during periods when financial assistance is provided and otherwise at least annually, on funding activities to the Board of Directors.

The Managing Director shall whenever necessary in view of pending lending requirements and market conditions approach the Board of Directors to decide on the amounts authorized the liquidity buffer. This authorization shall be revisited and renewed at least annually.