European Stability Mechanism

2020

Annual Report

Luxembourg: Publications Office of the European Union, 2021

PRINT	ISBN 978-92-95085-99-2	ISSN 2314-9493	doi:10.2852/512994	DW-AA-21-001-EN-C
PDF	ISBN 978-92-95223-00-4	ISSN 2443-8138	doi:10.2852/986767	DW-AA-21-001-EN-N

© European Stability Mechanism, 2021

Reproduction is authorised provided the source is acknowledged.

Photo credits:
ESM: pages 15 (photo number 3), 21, 30, 31, 34, 41, 44, 45, 53, 56, 59, 63
ESM, Steve Eastwood: pages 5, 64
European Union: page 15 (photo number 2)
UN-PRI: page 15 (image number 4)
Portrait photos: pages 10-11, 54-55, 57-59, 61 supplied by national ministries and institutions named

2020

Annual Report

Letter of transmittal to the Board of Governors

17 June 2021

Dear Chairperson,

I have the honour of presenting to the Board of Governors (BoG) the annual report in respect of the financial year 2020, in accordance with Article 23(2) of the By-Laws of the European Stability Mechanism (By-Laws).

The annual report includes a description of the policies and activities of the European Stability Mechanism (ESM) during 2020. It also contains the audited financial statements as at 31 December 2020, as drawn up by the Board of Directors (BoD) on 30 March 2021 pursuant to Article 21 of the By-Laws, which are presented in Chapter 4. Furthermore, the report of the external auditor in respect of the financial statements is presented in Chapter 5 and the report of the Board of Auditors (BoA) in respect of the financial statements in Chapter 6. The independent external audit was monitored and reviewed by the BoA as required by Article 24(4) of the By-Laws.

Klaus Regling
Managing Director

Contents

ESM at a glance

The ESM is a crisis resolution mechanism established by the euro area countries. Since its inauguration in October 2012, the Luxembourg-based ESM has provided financial assistance to ESM Members experiencing or threatened by severe financing problems to safeguard the financial stability of the euro area as a whole and of its member states.

On 30 November 2020, the Eurogroup agreed to proceed with the reform of the ESM. By signing the agreement amending the ESM Treaty in early 2021, ESM Members launched the ratification process by their parliaments. The scope of the reform, agreed by the euro area finance ministers in their report to the Euro Summit in December 2018, includes the refining of ESM precautionary instruments, enhancing the ESM's role in financial programme management, and setting up a common backstop for the Single Resolution Fund by the beginning of 2022.[1] The extended mandate will come into force when all 19 ESM Members ratify the revised ESM Treaty. For further details on ESM reform and its impact, see The Future of the ESM.

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

- loans to cover their financing needs;
- loans and direct equity injections to recapitalise financial institutions;
- primary and secondary debt market purchases of Members' national bonds;
- credit lines to be used as precautionary financial assistance.

To address the financial fallout from the coronavirus crisis, on 15 May 2020, the ESM Board of Governors approved the Pandemic Crisis Support credit line, available for ESM Members' direct and indirect health care, cure, and prevention-related costs.

For more information about ESM Treaty reform and Pandemic Crisis Support, see The Future of the ESM.

For more information about the ESM, visit our website.

Note: *ESM 2020 Annual Report* contains the audited financial statements as at 31 December 2020, together with the report of the external auditor in respect of their audit concerning these financial statements, and the report of the BoA in respect of these financial statements. The description of ESM policies and activities covers the 2020 financial year, except when stated otherwise. The information related to the composition of the BoG and BoD reflects their composition as of 23 April 2021. The economic development report (Chapter 1) includes certain information available up to 23 April 2021, but all historic financial data there set out is limited to the period to 31 December 2020.

[1] In parallel with other processes that have also started, the new role of the ESM as a common backstop to the Single Resolution Fund will be confirmed through the signature of an Intergovernmental Amending Agreement by the beginning of 2022.

"The ESM emerged from 2020 stronger, more robust and resilient to confront and overcome any future challenges to euro area financial stability."

KLAUS REGLING
Managing Director

Message from the Managing Director

Europe, like much of the world, is suffering a protracted and debilitating crisis brought on by the outbreak of the Covid-19 pandemic. Beyond the countless lives lost, countries, businesses, and families have faced crippling financial strain as waves of lockdowns designed to contain the illness undermined economic activity and imperilled livelihoods.

In the first months of the crisis, European leaders took swift, concerted steps to address the mounting distress. More recently, European leaders worked to secure euro area preparedness against future crises. To fortify the euro area against future shocks, Europe agreed to reform the ESM, further deepening Economic and Monetary Union.

Assume new mandates

In early 2021, euro area member states signed an agreement that broadens the ESM mandate to safeguard the common currency, kickstarting the ratification of the reformed ESM Treaty by national parliaments. The reform comprises three key elements:

- The ESM will serve as the common backstop to the Single Resolution Fund, the EU agency that resolves failing banks, should the Single Resolution Fund not have sufficient funds. Governments will not need to rescue large banks at the expense of taxpayers, as any money lent by the ESM will be repaid by the banking sector itself.

- The ESM will strengthen the preventive and precautionary features of its toolkit to enable rapid implementation of financial facilities in instances of extreme and sudden external shocks. Once implemented, it will be easier for countries to access these credit lines without extensive negotiations about policy conditionality when certain requirements are met.

- The ESM will strengthen its cooperation with the European Commission and will have an enhanced role in designing, negotiating, and monitoring future euro area stability programmes. The European Commission, in charge of policy coordination, will guarantee that EU provisions are always respected and the ESM will ensure that public resources are used effectively and that a borrowing country is able to repay the loans.

Provide aid in times of crisis

Soon after the crisis erupted in 2020, European leaders introduced the ESM's Pandemic Crisis Support credit line to fund health care measures to combat Covid-19, part of Europe's initial €540 billion response to aid the hardest-hit countries and cushion the blows to the European economy.

Although as yet untapped, the new credit line has calmed markets with its mere existence and its availability until the end of 2022.

Partner for results

As the crisis deepened, the ESM continued to work with its institutional partners to reduce distress, invigorate the euro economy, and further underpin the global financial safety net. In the following pages, you will hear from some of our closest institutional partners, explaining how we cooperate to these ends.

Transform crisis into change both externally…

Though painful, the current crisis also provides the opportunity to accelerate structural changes in our economies. Europe is funding its policy response with Environmental, Social, and Governance (ESG) matters in mind.

For example, the ESM intends to issue social bonds to fund the loans used for the Pandemic Crisis Support tool, enabling the ESG investor community to allocate its investments to support the social needs of euro area member states. To facilitate this, the ESM developed a social bond framework compliant with the International Capital Market Association's core social bond principles.

Additionally, the ESM signed the United Nations Principles for Responsible Investment, part of a global network for investors dedicated to integrating ESG considerations into investment practices, and has been embedding these criteria into its own investment processes.

...and internally

Under the extraordinary circumstances of the pandemic, the ESM faced the need to quickly prepare the Pandemic Crisis Support instrument for use, and meet the demands of current mandate obligations. By swiftly shifting to digital channels to foster connectivity and collaboration among staff and with our external stakeholders, the ESM protected the health of its staff and maintained business as usual to high standards.

The ESM ensured its front-, middle-, and back-office staff could continue to trade, process, and settle financial transactions remotely without incurring additional risks. Despite highly volatile financial markets rattled initially by the pandemic, the ESM succeeded in guaranteeing the smooth operation of both its funding and investment duties.

This experience allows us to assess potential future ways of working and build upon our existing foundation of business continuity and organisational resilience, further enabling the ESM to fulfil its mandate in environments of disruption, uncertainty, and change.

Deepen Economic and Monetary Union further

While focusing on the immediate economic recovery, we should also continue to deepen our monetary union.

More risk sharing within the euro area remains an overarching objective. Increased risk sharing via financial markets requires progress towards a capital market union and the completion of banking union. The introduction of the backstop is the next important step in this process. Work is ongoing in several other workstreams, including a common deposit scheme, to complete banking union.

Additional risk sharing via public channels will happen through the Next Generation EU package, but a fiscal capacity for macroeconomic stabilisation in the euro area is also needed to create additional fiscal space in a crisis.

Progress in these areas would make Economic and Monetary Union more resilient and less vulnerable in a future crisis; it would strengthen the growth potential through a better allocation of capital; and it would promote the international role of the euro.

Forge the future

The year 2020 has been one of growth and transformation for the ESM, the elements of which this report's cover reflects. We have new mandates when the ratification of the amended ESM Treaty is concluded, including the backstop to the Single Resolution Fund. We have a temporary new tool, the Pandemic Crisis Support credit line. And we have carried out our mandates, and prepared for our new obligations, while coping with and learning new ways of working and collaborating.

With this experience, the ESM emerged stronger, more robust and resilient to confront and overcome any future challenges to euro area financial stability.

The Future of the ESM

The Covid-19 pandemic and consequent sharp economic downturn spurred far-reaching policy decisions in the euro area during 2020. Among these were two key developments for the ESM: the creation of the Pandemic Crisis Support credit line and the finalisation of the ESM reform.

Because they support euro area financial stability, both milestones also reassure markets. The Pandemic Crisis Support tool's introduction in spring 2020, for example, swiftly helped to calm tumultuous markets. Similarly, the signature of the agreements amending the ESM Treaty and the Intergovernmental Agreement on the Single Resolution Fund (SRF) in early 2021 and the ongoing ratification process will, when final, introduce a number of important innovations in the euro area's crisis resolution response, further enhancing the ESM's crisis prevention and management capacities and crisis preparedness.

The new €240 billion Pandemic Crisis Support credit line is a temporary facility designed to finance direct and indirect health care, cure, and prevention-related costs brought on by the Covid-19 pandemic and can be requested until end-2022. The ESM showed its agility and flexibility by setting it up in record time on the basis of the existing ESM Treaty. The Pandemic Crisis Support is based on the existing Enhanced Conditions Credit Line (ECCL) and adjusted in light of the specific challenge arising from a symmetric exogenous shock. The only requirement to access the credit line is that the euro area member requesting support commits to using the credit line for supporting the costs mentioned above.

Though no ESM Member has yet requested Pandemic Crisis Support, investors and other market participants have recognised its benefits and its existence has served as a very effective firewall, reassuring markets and helping to underpin euro area financial stability. The new credit line, should it be used, could be financed through social bonds, demonstrating the ESM's dedication to its evolving ESG commitments. This could provide useful lessons for the financing of ESM stability support going forward.

While the political agreement on the ESM Treaty reform precedes the Covid-19 crisis, the enhancement of the ESM's role better equips the euro area to deal with future crises. The reform establishes the ESM as the common backstop to the banking union fund that resolves failing banks, the SRF. The backstop may only be used as a last resort if SRF funds are depleted, ex post contributions are not sufficient or not immediately available, and the Single Resolution Board is unable to raise sufficient funds at acceptable rates. The backstop, which should enter into force by the beginning of 2022 as agreed by the Eurogroup in November 2020, will be able to provide loans to the SRF of up to an amount equal to its target size, with a nominal cap of €68 billion, doubling SRF resources and ensuring immediate availability.[2] The backstop should, like the Pandemic Crisis Support instrument, work as a firewall to reassure markets and limit contagion effects, whether called upon or not. Banking sector contributions fund the SRF and will also be used to repay any ESM backstop loans ensuring its use and that of the ESM backstop minimise costs of banking crises for taxpayers and the real economy. As a major building block of banking union, the ESM acting as a backstop will contribute to further weakening the bank-sovereign

[2] Until end-2023, the size will be aligned with the actual size of the SRF, not taking into account possible disbursements from the SRF. The nominal cap may be adjusted by the Board of Governors by mutual agreement. The Board of Directors will make disbursement decisions by mutual agreement guided by the criteria specified in Annex IV of the amended ESM Treaty.

nexus and thereby address one of the remaining gaps in the euro area architecture. In parallel to the set-up of the common backstop facility, the ESM instrument of direct recapitalisation of credit institutions will be cancelled.

The revised treaty gives the ESM a stronger role in future financial assistance programmes and crisis prevention, reinforcing not only the ESM's crisis preparedness but also that of the euro area as a whole, in full respect of the Commission and European Central Bank competences as laid down in the European Union (EU) legal framework. In collaboration with the European Commission, the ESM will design, negotiate, and monitor future assistance programmes. When the treaty is ratified, the ESM and the European Commission will sign a mutually agreed Memorandum of Cooperation detailing how their collaboration will work. The amended treaty also empowers the ESM to, where relevant, follow and assess the macroeconomic and financial situation of its Members to be internally prepared and enable it to pursue its tasks appropriately and in a timely manner. The functions of economic policy coordination will remain with the Commission.

In addition, the reform strengthens the preventive features of the ESM toolkit. The eligibility process for the Precautionary Conditioned Credit Line (PCCL) will be made more transparent and predictable and the requesting country will no longer sign a Memorandum of Understanding. In order to qualify for a PCCL, a requesting euro area member would need as a rule to comply with a set of eligibility criteria anchored in the treaty. The ECCL instrument will continue to be available as foreseen in the current guideline. Access to an ECCL will remain open to ESM Members that are not eligible for the PCCL due to non-compliance with some eligibility criteria, but whose general economic and financial situation remains sound and whose government debt is sustainable.

The revised treaty also foresees the introduction of single-limb collective action clauses in euro area government securities as of January 2022, which aim to address the problem of so-called 'holdout' investors, whose refusal to participate in debt restructurings can deepen financial crises.

Finally, under the revised treaty the ESM may only provide stability support to Members whose debt is considered sustainable and whose repayment capacity to the ESM is confirmed. The assessment of debt sustainability and repayment capacity will be carried out – together with the European Commission – on a transparent and predictable basis, while allowing for a sufficient margin of judgement. In the future the ESM may, at the request of a Member, facilitate a dialogue between that Member and its private investors on a voluntary, informal, non-binding, temporary, and confidential basis.

The introduction of the Pandemic Crisis Support credit line forms part of the policy response to combat the effects of the pandemic, while the ESM Treaty reform strengthens the resilience and crisis resolution capacities of the euro area. With this reform, both the ESM and the euro area begin a new chapter, emerging better equipped from the current crisis to tackle any future ones.

On the following pages, our institutional peers from the European Commission; the European Investment Bank (EIB); the European Central Bank (ECB); the International Monetary Fund (IMF); the Single Resolution Board (SRB), which runs the bank resolution fund for banking union– the SRF; and the President of the Eurogroup of euro area finance ministers share their views on future collaboration with the ESM and on working together to strengthen crisis prevention.

Our ESM peers: stronger together

WHY IS THE ESM TREATY REFORM SO IMPORTANT AT THIS STAGE?

"The unprecedented circumstances of the past year have illustrated how essential it is that our shared European structures are capable of meeting the common challenges we face. The enhanced ESM mandate will strengthen the resilience of the euro area by improving its ability to prevent and resolve any future crises."

Paschal Donohoe
President, Eurogroup

HOW WILL THE ESM CONTRIBUTE TO MAKING ECONOMIC AND MONETARY UNION MORE ROBUST AND RESILIENT?

"The ESM reform is an important step forward in how the European Commission and the ESM work together. The new treaty will allow both sides to be more involved in the work directly affecting the safety of ESM funds. It will help us to serve the euro area's economy and people even better – together. Along with the more accessible precautionary credit line and early introduction of the backstop, this is all excellent news for the euro area."

Valdis Dombrovskis
Executive Vice-President, European Commission

HOW WILL THE ESM AND THE COMMISSION WORK TOGETHER GOING FORWARD?

"In 2020, the ESM and the European Commission worked intensively together to create the Pandemic Crisis Support in response to the Covid-19 emergency. In just a few weeks last spring, we were able to develop a new instrument of solidarity, without macro-conditionality, which remains available to all euro area member states. I look forward to continuing our excellent cooperation."

Paolo Gentiloni
Commissioner for Economy, European Commission

WHAT IS THE IMPORTANCE OF THE ESM TREATY REFORM FOR EURO AREA FINANCIAL STABILITY?

"The ESM Treaty reform is a major step for financial stability in the euro area. As the backstop to the Single Resolution Fund, the ESM strengthens the bank resolution framework and helps safeguard financial stability. It is another crucial milestone towards the completion of our banking union."

Christine Lagarde
President, European Central Bank

HOW DO YOU ENVISAGE THE EUROPEAN INSTITUTIONS TOGETHER BUILDING A STRONGER EUROPE?

"While still being a young sister institution, the ESM is a crucial pillar of the European financial architecture. The backstop that it provides ensures the integrity of the eurozone and the internal market. It improves the lives of EU citizens and facilitates the EIB's role to invest in Europe's future."

Werner Hoyer
President, European Investment Bank

HOW DO YOU ENVISAGE COOPERATION AMONG THE ESM, OTHER REGIONAL FINANCING ARRANGEMENTS (RFAS), AND THE IMF GOING FORWARD?

"The IMF has worked closely with the ESM and other RFAs in recent years to strengthen the global financial safety net. We will continue this cooperation to best serve our members, especially during a period of tremendous social and economic challenges posed by the pandemic."

Kristalina Georgieva
Managing Director, International Monetary Fund

WHAT WOULD BE THE BACKSTOP'S MAIN CONTRIBUTION TO THE SINGLE RESOLUTION BOARD'S FUTURE OPERATION?

"The backstop reinforces the resilience of the bank crisis management framework by establishing a last resort credit line to the Single Resolution Fund that is designed to be fiscally neutral. As of 2022, we will ensure operational readiness so funds can be drawn, if conditions are met. This will enable us to address bank failures, while limiting impacts on the economy, public finance, and financial stability."

Elke König
Chair, Single Resolution Board

How the ESM adapted its operations during the pandemic and beyond

Covid-19 transformed the ESM's internal and external operations. As an employer, the ESM strove to protect the physical and emotional health of its staff; and, as a public institution accountable to its shareholders – the euro area countries – it devoted its efforts to ensuring it could fulfil its public mandate at all times. During these uncertain times, the ESM benefitted from a strong business continuity plan and organisational resilience.

When the World Health Organization declared the outbreak of Covid-19 a public health emergency of international concern in January 2020, the ESM drew upon its existing business continuity plan. The plan provided a useful blueprint for a swift and effective response, including to a pandemic – from restricting business travel to reviewing the contingency arrangements of key service providers and ensuring continuous operations.

Early on, a dedicated incident management team, responsible for taking the lead in navigating crises that threaten to disrupt business operations, started advising the Managing Director on appropriate actions. Already in the first weeks of 2020, the team met to assess the pandemic risks and propose timely and measured responses to the unfolding situation. The first priority was to establish procedures to protect staff and minimise the risk of contagion within the ESM's premises.

In February, the ESM tested how robust its technology and networks would be should the circumstances require all staff to telework. When the situation deteriorated further in March, the ESM asked most staff to work from home, with only a small core team remaining in the office. The ESM's reliable information technology infrastructure and systems allowed for a seamless transition.

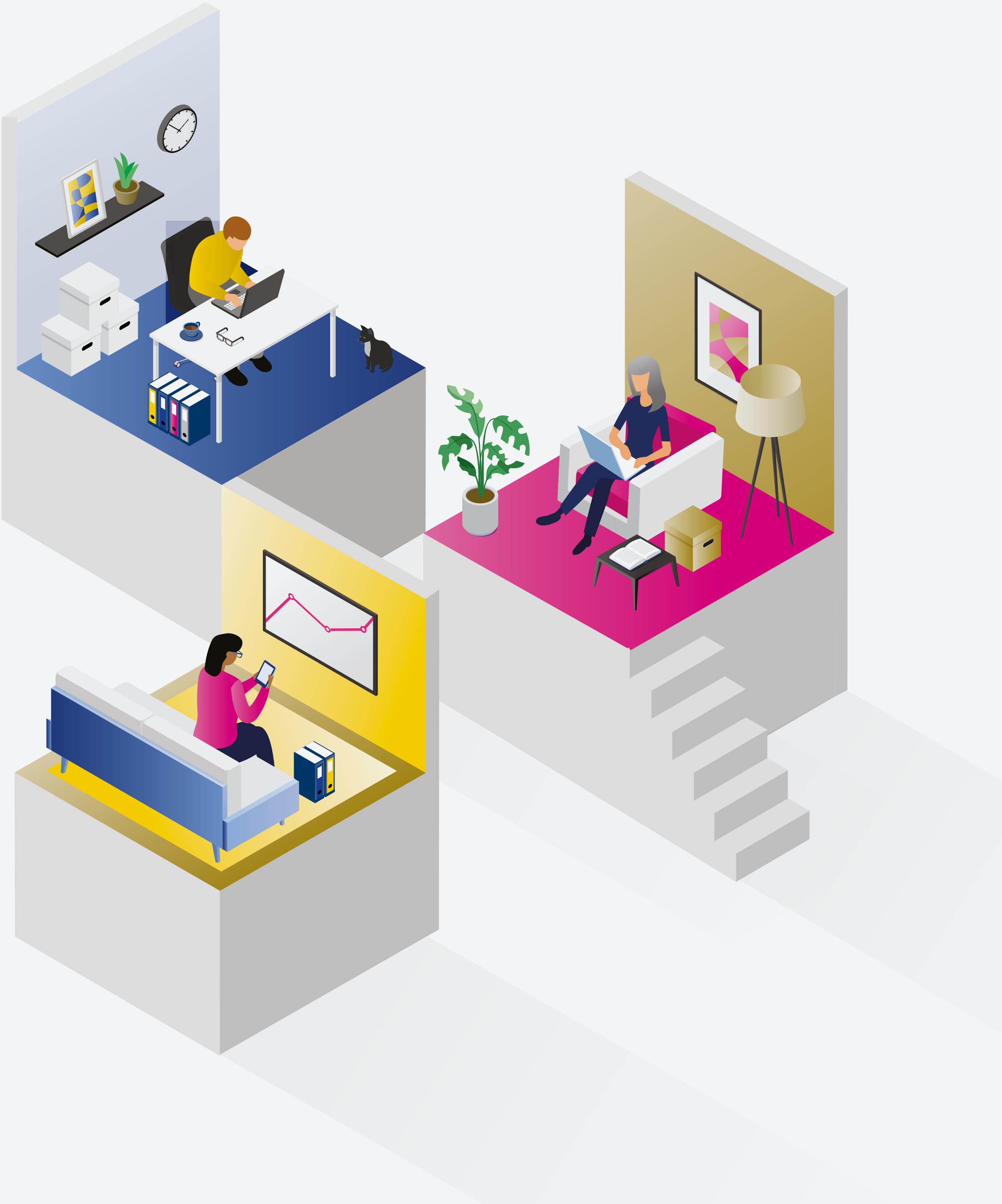
The ESM also quickly deployed a variety of digital channels to foster connectivity and reinforce collaboration among staff and ESM external stakeholders. Videoconferencing became not only an essential daily routine for all ESM staff, but also an indispensable tool for our meetings with investors, peer institutions, and credit rating agencies, as well as for the important institutional meetings of our governing bodies.

In addition, the ESM adjusted its financial operations to enable front-, middle-, and back-office staff to trade, process, and settle financial transactions remotely, amending several processes and related controls to ensure these operations could be handled without additional risks. With these adjustments, the ESM was able to ensure its funding operations and to trade a record amount of securities for its investment portfolios in highly volatile financial markets.

As the situation evolved, the ESM scaled up digital initiatives, maintaining business as usual to high standards. It proceeded, for example, with its planned recruitment on schedule, and adapted all recruitment, on-boarding, and training processes to e-learning platforms. The institution gave extra consideration to emerging threats such as information security and cyber risks, with management regularly reviewing project priorities and annual objectives to ensure appropriate resource allocation.

The ESM also continuously updated its teams about the organisation's response to the outbreak and actively supported staff's emotional and physical well-being. It prioritised staying connected and caring for staff, their families, and society by, for example, organising various social activities and charity events online, creating inspirational staff videos, and providing care packages containing protective face masks. It also made additional equipment available to staff for home working to improve productivity and wellbeing.

While managing the ongoing crisis, the ESM has also begun to analyse the experience thus far and to assess potential future ways of working, building upon the principles of agility, resilience, collaboration, and inclusion. The continuation of such careful analysis with ongoing learning and accurate planning will further enable the ESM to withstand disruption, and even thrive in an environment of change and uncertainty.



2020 year in review

09.01
EFSF BoD approves reduction to zero of the step-up interest margin accrued by Greece from 17 June to 31 December 2019, as part of the medium-term debt relief measures agreed in 2018, saving Greece €122.15 million.

15.01
ESM adjusts capital contribution keys for 15 of its Members following the end of the temporary correction period for Malta.

06.02
ESM BoD agrees to waive Cyprus' mandatory repayment obligation of ESM loans tied to its early repayment to the IMF.

27.02
ESM signs and begins working towards implementing the United Nations Principles for Responsible Investment (UN-PRI).

09.04
Eurogroup agrees on a comprehensive economic policy response to the Covid-19 crisis, including a safety net for sovereigns that the ESM will provide under the Pandemic Crisis Support credit line.

15.05
ESM BoG approves the establishment of the Pandemic Crisis Support tool, available to all ESM Members until end-2022 to finance Covid-19 related health care costs.

11.06
ESM BoG holds its first virtual Annual Meeting, and endorses the 2019 Annual Report and ESM's transparency measures. Independent Evaluator Joaquín Almunia presents his report *Lessons from the Financial Assistance to Greece*, which is then made public.

25.06
ESM publishes its first social bond framework, which will be used for issuing social bonds to finance the Pandemic Crisis Support tool if requested by ESM Members.

01.07
ESM and EIB co-organise an online investor seminar on capital markets and pandemic recovery.

07.07
EFSF BoD approves reduction to zero of the step-up margin accrued by Greece from 1 January to 17 June 2020 as part of the medium-term debt relief measures agreed in 2018, saving Greece €103.64 million.

17.07
ESM BoG appoints Eurogroup President Paschal Donohoe as its Chairperson, succeeding Mário Centeno.

13.08
ESM welcomes the decision by S&P to assign ESM a long-term AAA rating, its first ESM rating.

06.10
ESM co-organises with the Bridge Forum Dialogue and EIB a high-level virtual conference to mark the 50th anniversary of the Werner Report and 10th anniversary of the euro area rescue funds.

13.10
Fifth High-level RFA Dialogue, co-organised by the ESM, takes place in a virtual format.

30.11
Eurogroup agrees to proceed with ESM reform and to advance the entry into force of the common backstop to the SRF. By signing the agreements amending the ESM Treaty and the intergovernmental agreement on the backstop in early 2021, the ESM Members launch the ratification process.

1.

2.

3.

4.

5.

1. The ESM independent evaluation on EFSF and ESM financial assistance to Greece, published in June 2020.
2. Following the decision to proceed with ESM Treaty reform in late 2020, ESM Members signed the agreement to amend the treaty in early 2021, initiating national ratification procedures.
3. Chief Financial Officer Kalin Anev Janse (bottom pair, right) holds up a plaque commemorating the EFSF's inaugural benchmark issue in celebration of an early January 2021 €70 billion issuance book in one of the many virtual meetings to take place since the ESM transformed its operations to digital formats.
4. After signing the UN-PRI in early 2020, the ESM is embedding those guidelines in its investment practices.
5. In spring 2020, the euro area introduced the ESM Pandemic Crisis Support credit line to finance health care costs stemming from the Covid-19 pandemic.

01 Economic developments

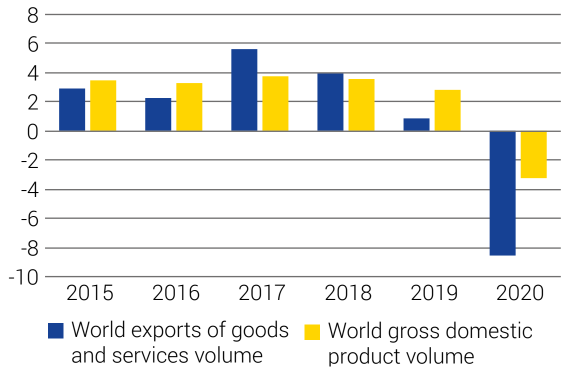
Macroeconomic and financial environment

Uncertain recovery after historic shock

The Covid-19 pandemic provoked the worst economic downturn since the Great Depression. This crisis tested Europe's health care capacity and triggered a severe economic recession. The global contraction reached its trough in April, followed by a slight improvement from May, but a second wave of infections and lockdown measures to contain the pandemic struck economic activity again towards the end of the year. A robust policy response helped contain the economic and social fallout and governments launched sizeable fiscal support measures. At the European level, measures included safety nets for workers and businesses and ESM support for sovereigns, the European Commission's Recovery and Resilience Facility commencing in 2021 and the ECB's Pandemic Emergency Purchase Programme.

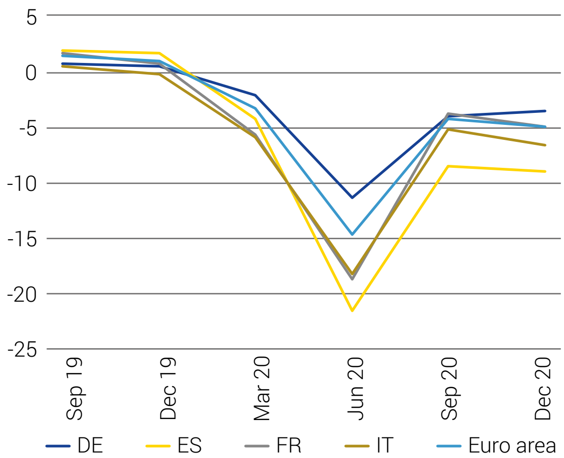
Hit by the pandemic, global economic activity and trade dropped sharply in 2020 – gross domestic product (GDP) fell by 3.3% (Figures 1 and 2). Disruptions in global supply chains and weaker demand for exports adversely affected manufacturing and global trade, while the pandemic and resulting containment measures also dragged down domestic production and demand. Industrial production dropped 15.3% year-on-year in April, and global trade was down by 18% compared to a year earlier in May, while global economic policy uncertainty soared to all-time highs.

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



Source: IMF World Economic Outlook, April 2021

Figure 2
Real gross domestic product growth for selected countries
(y/y growth in %, quarterly data)

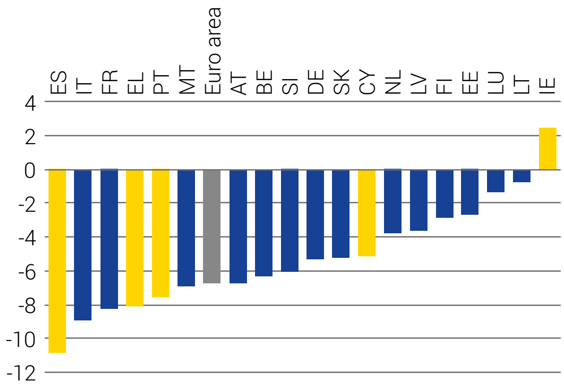


Source: Eurostat

The Covid-19 pandemic led to a sharp drop of 6.6% in euro area 2020 GDP growth. The pandemic induced a combination of supply and demand shocks that dragged real GDP down in all euro area countries, except Ireland (Figure 3). The lockdown measures implemented in mid-March curtailed private consumption, investment in construction, machinery and equipment, and exports. As governments gradually eased lockdown measures, household consumption, investments, and exports snapped back and Europe experienced a strong economic activity rebound in the third quarter. A resurgence of infection rates prompted tighter containment measures resulting in another GDP contraction in the fourth quarter (Figure 4).

The pandemic hit all European countries but the severity of the impact and the economic propagation across euro area countries and sectors differed substantially, reflecting varied exposure, economic structures, and national responses. Overall, the crisis most severely hit services and manufacturing with the latter showing a slightly quicker and stronger rebound (Figure 5). Urban areas, with a higher concentration of services directly affected by restrictions, and regions more reliant on tourism were worst hit. The longer-term economic consequences will likely differ across regions depending on their exposure to particular sectors, their integration into supply and marketing chains, and structural changes in economic behaviour leading to persistently different consumption patterns.

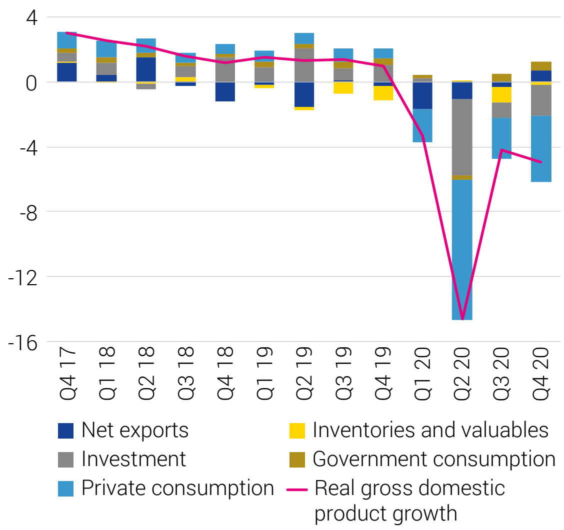
Figure 3
Real gross domestic product growth in 2020
(in %)



Notes: EFSF/ESM post-programme countries in yellow. Multinational corporations' activities distort GDP figures in Ireland, with modified final domestic demand a measure for domestic economic activity corrected to reflect the influence on multinational corporations and seen as a more accurate reflection of the Irish economy.

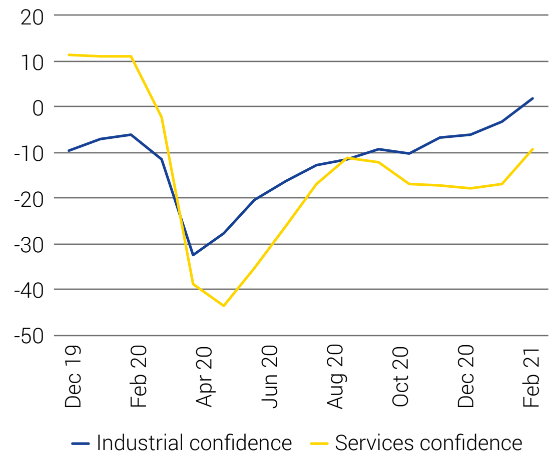
Sources: Eurostat, European Commission

Figure 4
Contributions to real gross domestic product growth
(y/y growth in %, contributions in percentage points)



Source: Eurostat

Figure 5
Euro area industrial and services confidence indicators
(in %)



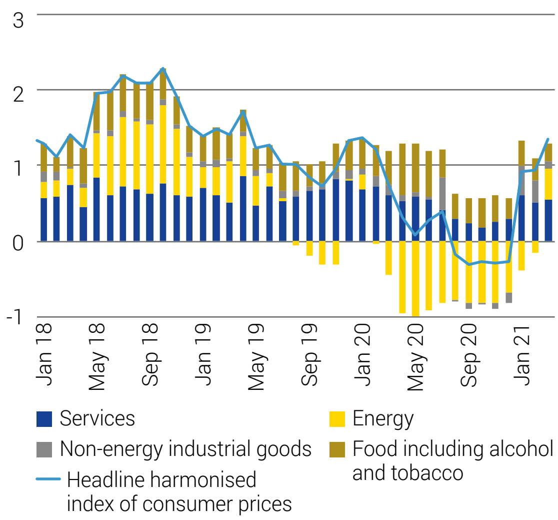
Notes: The confidence indicators are produced to reflect overall perceptions and expectations at the individual sector level in a one-dimensional index. For each of the six surveyed sectors, they are calculated as the simple arithmetic average of the (seasonally adjusted) balances of answers to specific questions chosen from the full set of questions in each individual survey.

Source: European Commission

Euro area inflation fell sharply to 0.3% in 2020 after subdued inflation of 1.2% in 2019 (Figures 6 and 7). A drop in energy prices and a global and domestic demand contraction resulted in deflationary pressures. Wages fell sharply starting from the second quarter of 2020. Given weakened demand, firms started accepting lower profit margins, reducing wages, and passing lower costs on to consumers. Core inflation stayed at 1% for the first half of the year followed by a decline and levelling off at 0.2% in the fourth quarter, reaching historic lows. Market-based long-term inflation expectations, following an initial fall in the first two quarters, recovered in the second half of the year to pre-pandemic levels, reaching 1.25% in December.

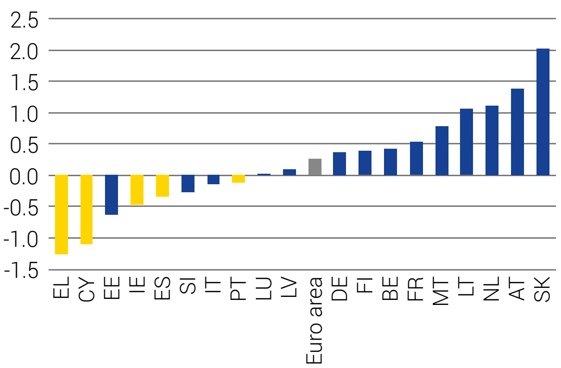
Supported by the activation of the general escape clause of the Stability and Growth Pact, euro area governments introduced large fiscal measures which, together with automatic stabilisers, added up to 8% of GDP (Figures 8 and 9), albeit with substantial variation across countries. The measures aimed to contain the pandemic, support health systems, guarantee the functioning of essential services, alleviate the economic and social consequences, and facilitate a sustained recovery.

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



Source: Eurostat

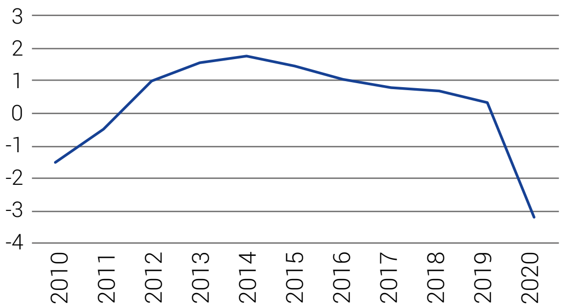
Figure 7
Harmonised index of consumer price inflation rates in 2020
(in %)



Note: EFSF/ESM post-programme countries in yellow.

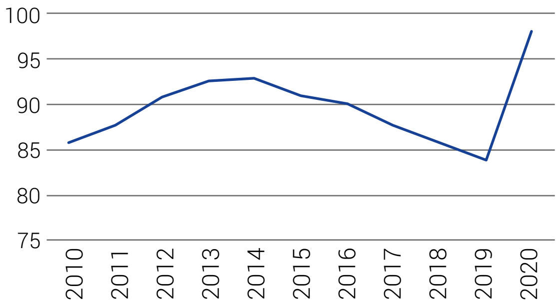
Source: Eurostat

Figure 8
Euro area fiscal effort in 2020/annual change in the structural primary balance
(in % of potential GDP)



Source: European Commission Autumn 2020 Economic Forecast

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

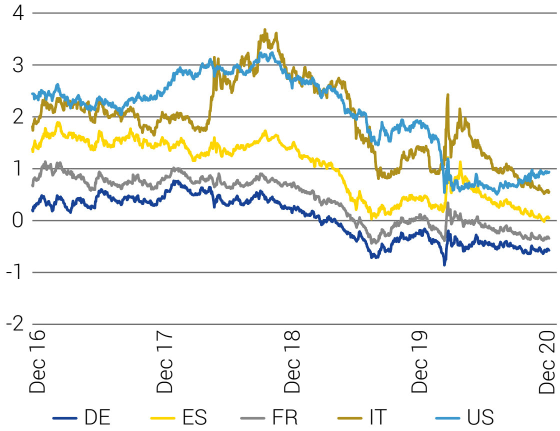


Source: Eurostat

Beyond national measures, an unprecedented effort at European level comprised safety nets for workers, businesses, and sovereigns totalling €540 billion, a new recovery instrument – Next Generation EU (€750 billion in 2018 prices) commencing in 2021, and the ECB's Pandemic Emergency Purchase Programme. In addition, an ESM credit line for euro area member states to support domestic financing of direct and indirect health care, cure, and prevention-related costs due to the Covid-19 crisis was rapidly adopted in May 2020. The Recovery and Resilience Facility, the main component of Next Generation EU, consists of grants and loans to support public investment and reforms in the Member States, concentrated where the crisis impact and resilience needs are greatest, towards a sustainable and inclusive recovery that promotes the green and digital transitions.

The shock of the Covid-19 pandemic combined with an oil price drop rattled global markets in the first quarter: the VIX index, a measure of global risk aversion, spiked above the levels seen in 2009; the S&P Global Ratings (S&P) 500 and European equity indices suffered their fastest-ever drops, while United States (US) Treasury as well as Bund yields declined to the lowest on record (Figure 10). On euro area sovereign debt markets, spreads widened abruptly and liquidity became scarce.

Figure 10
10-year government bond yields of the US and selected euro area member states
(in %)



Source: Bloomberg

In response, global central banks acted forcefully. The ECB increased its Asset Purchase Programme, launched the Pandemic Emergency Purchase Programme, introduced a number of additional credit providing operations, and enhanced the terms of its targeted long-term refinancing operations in March, which helped to reduce uncertainty, stabilise markets, and improve liquidity. Sovereign credit spreads of euro area member states compressed in the second quarter and reverted to their pre-pandemic range by the end of the year, also supported by the joint European fiscal response to the pandemic.

Early 2021 developments

In the first months of 2021, a sharp resurgence of Covid-19 cases required a renewed tightening of containment measures in many Member States. Delays in the administration of mass vaccinations in Europe and the emergence of more contagious strains of the virus dampened the initial brightening of expectations surrounding the availability of vaccines.

Financial markets looked beyond the near-term hurdles, and long-term government bond yields increased, particularly in the US. In Europe market-implied long-term inflation expectations have been rising modestly in the first months of 2021, but the accommodative monetary policy stance has contained an increase in long-term government bond yields. Still, inflation expectations for 2021 and 2022 remain well below the ECB target. High uncertainty remains around the duration and magnitude of the shock and the timing and speed of the subsequent recovery.

Against this backdrop, the Eurogroup recalled in March its commitment to a supportive stance in the euro area in 2021 and in 2022, also taking into account the European fiscal stimulus, notably from the Recovery and Resilience Facility.

Former programme country experiences

Ireland

EFSF

The Irish economy continued to grow in 2020 despite the Covid-19 pandemic. Strong exports offset the sharp decrease in domestic demand. Exceptional pandemic-related expenditures caused a sizeable general government deficit. Very favourable market access conditions allowed Ireland to maintain sizeable end-year cash buffers. Irish banks proved resilient to the pandemic shock despite weak profitability.

Real GDP expanded by 3.4% in 2020 thanks to rising exports, despite successive lockdowns to contain the pandemic. The strong export performance of multinational firms domiciled in Ireland cushioned the pandemic-induced decline of economic activity of domestically oriented businesses. A measure for domestic economic activity corrected for the influence of multinational firms, known as modified final domestic demand, declined by 5.4% due to the weakness of consumer spending and construction activity during the lockdowns. The unemployment rate increased to 5.7% from 5% in 2019, in stark contrast to the Covid-19 adjusted unemployment rate of 21.5%.[3] While headline inflation turned negative in April 2020 due to a fall in energy prices and a drop in demand, the pandemic induced an increase in the share of household expenditures on more inflationary items such as groceries.

The pandemic crisis interrupted Ireland's two consecutive years of budget surpluses and led to a sizeable deficit of 5% of GDP in 2020. The fall in consumption and deferral of some payments took a heavy toll on indirect taxes, with VAT and excise receipts recording sharp declines. Direct taxes, however, held up, mainly thanks to robust income tax and corporate tax revenues. The latter continued their positive trend of recent years, notwithstanding the potential instability of a significant portion of corporate taxes stemming from multinational companies. Targeted fiscal support measures in response to the crisis raised expenditure significantly, with social protection and health care costs driving the surge. General government debt increased to 59.5% of GDP in 2020, from 57.4% in 2019. According to alternative scaling metrics, which isolate the effects of highly mobile activities of multinational companies that distort the GDP figures, the debt level remains high.

Ireland continued to enjoy very favourable market access conditions in 2020, supported by stable credit ratings in the AA and A range, and the ECB's monetary policy measures. After an initial increase in yields in March 2020, Irish government bonds ended the year with the 10-year yield in negative territory. The average long-term bond funding cost in 2020 fell to 0.2% from 0.9% in 2019. Despite the public health crisis, very low borrowing costs have provided the National Treasury Management Agency with more flexibility in executing its funding plan, and bond issuance was at the upper bound of the revised €20 to €24 billion range announced in April. This helped close 2020 with sizeable cash buffers. The weighted average maturity of Irish government bonds is above 10 years, one of the longest in Europe.

Irish retail banks started 2020 with strong loss-absorbing capacity and improved quality of credit exposures. The banking sector, supported by a prompt policy response, withstood an initial pandemic shock. Banks' profitability remained weak due to significant increases in loan loss provisions in anticipation of Covid-19 related asset quality deterioration. Despite banks' continuing efforts to reduce operational costs over 2020, the aggregate sectoral cost-to-income ratio remained stable. Liquidity ratios remained steadily above the regulatory minima. The sector continued to benefit from an ample deposit base.

Under its Early Warning System, the ESM monitors risks to its loan service payments. While the economy overall showed greater resilience than euro area peers, and the risk of a no-deal Brexit has been averted, uncertainty surrounding the economic and fiscal outlook remains elevated. Risks related to the vaccine roll-out and trade frictions linked to the change in EU – United Kingdom (UK) trade relations since January 2021, and potential changes to the international tax regime, warrant fiscal prudence.

[3] The Covid-19 adjusted unemployment rate classifies all claimants of the Pandemic Unemployment Payment, a job retention scheme, as unemployed, and provides an upper bound estimate of unemployment. Average rate for the period March to December 2020.

Greece

The pandemic interrupted a three-year economic recovery and led to a sizeable general government deficit for the first time since 2015. GDP fell sharply, mainly stemming from the drop in tourism and the measures to contain the spread of Covid-19. The recession and tailored aid measures pushed the budget into large deficits. Favourable market conditions, supported by the ECB programmes and the Next Generation EU recovery plan, enabled the country to cover the elevated financing needs and maintain high cash balances. Greek banks have so far weathered the impact of the pandemic and provided an increasing amount of loans to firms, largely thanks to supervisory flexibility and national support schemes.

After strong growth since 2017, the pandemic triggered a recession with an 8.2% drop in 2020 GDP. The plunge in tourism hit the economy hardest, while domestic consumption fell less because of the government's substantial income support for sectors most affected by the pandemic. Despite comparatively resilient goods exports, the deterioration in the service balance widened the current account deficit markedly.

The recession and the targeted fiscal measures to tackle the health crisis and support the economy shrank revenues and inflated expenditures. After achieving large primary surpluses for four years in a row, the primary balance in programme terms showed a deficit of 7.5% of GDP in 2020. This deficit, together with the drop in GDP, forced the government debt ratio higher to 205.6% of GDP.

After some volatility at the outset of the pandemic, funding costs declined in 2020, on the back of the inclusion of Greek bonds in the ECB's Pandemic Emergency Purchase Programme and their eligibility as Eurosystem collateral, as well as the agreement on the Next Generation EU recovery plan. In 2020, the Public Debt Management Agency (PDMA) raised €12 billion through five issuances, further developing the yield curve in the 7-, 10- and 15-year spectrum. More recently in March 2021, the PDMA successfully issued a 30-year bond. To reduce debt and create space for funding activity while maintaining the high cash buffer, the PDMA performed liability management operations, including partly prepaying IMF loans in early 2021.

Despite the recession, banks continued to meet capital requirements in 2020 but profitability remained weak. Liquidity and funding conditions improved, in particular following the ECB's collateral easing measures, and lending to the economy resumed, buttressed also by government support. The 'Hercules' Asset Protection Scheme accelerated non-performing loan (NPL) reduction in 2020 and was recently extended until 2022, but NPL ratios remain very high. The Hercules scheme benefitted from state guarantees of €12 billion.

Following the European institutions' overall positive assessment of progress on its commitments under enhanced surveillance, Greece received the third and fourth tranches of the semi-annual conditional debt relief measures amounting to €1.5 billion. Also, due to favourable ESM and EFSF lending terms, the country enjoyed budget savings estimated to amount to €8 billion in 2020.[4] Among key improvements, Greece implemented the 'Hercules' scheme and attracted investors to purchase large NPL portfolios; certain key privatisations made further progress, and the Hellenic Corporation of Assets and Participations continued state-owned enterprise governance improvements and achieved good financial results. The overhaul of the insolvency code, aimed at strengthening the reduction of NPLs, was adopted in 2020 and its full implementation is expected in 2021. However, the pandemic triggered some policy re-prioritisation and disrupted the implementation of some reform efforts. In particular, the plan to reduce non-pension related arrears to almost zero by end-2020 was not achieved.

Under its Early Warning System, the ESM monitors risks to its loan service payments. From this perspective, the very high level of public debt presents a significant vulnerability. Achieving strong long-term growth, returning to a fiscal path that complies with the European fiscal framework, and enhancing resilience are the critical challenges to ensure debt sustainability. This depends decisively on boosting productivity and encouraging investment, as demographic shifts will dampen the growth contribution from labour in the long term. Fuelling economic activity requires efforts across many policy areas, including continued implementation of the structural reform agenda initiated during the ESM programme and real-

[4] The ESM estimates the budget savings by comparing the lending rates on ESM/EFSF loans with the interest rates that the country would have faced had they covered the disbursed amounts in the market. For Greece, these estimates are based on the spread between the estimated seven-year market rates at the time of disbursements and the actual ESM/EFSF cost.

ising the ambitious growth strategy for the restart of the economy. Full absorption and efficient use of the available European funds, which amount to more than 10% of GDP, provide a unique opportunity to increase the economy's productivity through investments in more capital-intensive and digitalised structures with a correspondingly re-skilled labour force. To enable banks to support such an investment-driven growth model, further reductions of the high NPL stock are necessary. Supporting the recovery and safeguarding banks' resilience remains the priority, underpinned by full implementation of the long-anticipated insolvency law reform. All this can go hand in hand with further strengthening of the social safety nets and meeting the enhanced surveillance commitments to the Eurogroup.

Spain

Spain was hard hit by the Covid-19 pandemic. The pandemic caused substantial increases in the budget deficit and debt ratios. The Spanish Treasury nonetheless maintained very favourable market access throughout 2020, which allowed funding costs to reach new historic lows. Spanish banks' profitability was negatively affected by the pandemic, but benefitted from supervisory and government support measures and from balance sheet strength gained over the last decade.

Real GDP contracted by 10.8% in 2020, after six years of strong growth. Measures taken to contain the pandemic strongly affected the tourism and hospitality sectors in particular, which Spain relies upon highly. Despite declines in tourism revenues, Spain retained a current account surplus in 2020, for the eighth consecutive year since 2013. The pandemic took a heavy toll on public finances. The budget deficit is estimated at about 11%, while the debt ratio is projected to have increased to 120% of GDP at the end of 2020, partly due to the severe contraction in GDP. Prior to the pandemic, Spain's debt ratio was following a downward trend and reached 95.5% in 2019. Spain exited the excessive deficit procedure in 2019 for the first time since 2009. After having operated under the preceding administration's budget since 2018, the current government passed its own budget for 2021 late last year.

The government's short-term work scheme successfully dampened the effect of the pandemic on Spain's labour market. At its peak in spring, 3.4 million people were part of the scheme, a number that fell to around 755,000 in December 2020. The unemployment rate stood at 16.1% of the active population at year-end. This is far below levels reached during the sovereign debt crisis, but still reflects an increase of 2.3 percentage points since the end of 2019. Youth unemployment climbed to 40.1% by end-2020. Employment shrank by 3.1% year-on-year overall, but started recovering in the third quarter of 2020. Private debt expanded to 143% of GDP in consolidated terms at the end of the third quarter of 2020, after having declined substantially in prior years to below 133% of GDP in 2019 from above 200% in 2010.

Spain retained very favourable market access in 2020, as reflected by the increase in the bid-to-cover ratio. Along with other euro area member states, Spain experienced market turbulence in March, but ECB monetary policy measures and the coordinated national and European economic policy responses stabilised markets and Spain's debt issuance remained on track. Yields continued to fall, reaching new historic lows, and spreads versus Germany narrowed to below 70 basis points in December. More than half of the debt issued by the Treasury during the year was allocated at negative rates.

Spanish banks' profitability fell during 2020, as with other member states, but the NPL ratio also declined due to government guarantee schemes and loan moratoria. Banks' capital ratios remained lower than in other euro area countries but above supervisory standards. Two mergers were approved in Spain during 2020 that could improve profitability in the long term, as banks have continued to strengthen their balance sheets in the face of the pandemic.

Under its Early Warning System, the ESM monitors risks to its loan service payments. The economic outlook for Spain for the near term is subject to substantial uncertainty, stemming from the evolution of the pandemic, the pace of vaccinations, the effectiveness of the use of Next Generation EU funds, and the speed of recovery of the tourism sector. Despite this uncertainty, growth expectations for Spain for 2021 and 2022 are among the highest in the euro area.

Cyprus

Cyprus' economy shrank in 2020 due to the pandemic, albeit by less than the euro area average and with only a moderate rise in the unemployment rate. Though public debt and government financing needs increased significantly, Cyprus enjoyed favourable financing conditions and maintained a large liquidity buffer. Decreasing, although still high, NPLs and the loan payment moratoria limited the pandemic's drag on banks' balance sheets. Structural reforms in several areas would help to boost the country's longer-term growth potential.

Cyprus reported a large GDP drop in 2020, although smaller than the 6.6% euro area average decline. After expanding by 3.1% in 2019, real economic activity shrank by about 5.1% in 2020 largely because of the collapse in tourism. Domestic demand, however, remained relatively resilient, and government support schemes for the economy cushioned the impact of the crisis. The unemployment rate stood at 7.3% in December 2020, below the euro area average of 8.2%.

The fiscal deficit widened sharply in 2020, resulting in sizeable gross financing needs. The primary deficit stood at about 3.5% of GDP in 2020, about half the euro area average. More than half of the deficit was due to automatic stabilisers reacting to the fall in economic activity, while the remainder stemmed from discretionary measures designed to mitigate the economic effects of the pandemic. Public debt increased to above 118% of GDP in 2020 from 94% a year earlier, while limited contingent liabilities might arise from government guarantees granted in previous years to the private and public sector to sustain the economy. The main credit rating agencies, with the exception of Moody's, continued to rate Cyprus' debt at investment grade. Sovereign creditworthiness was constrained due to vulnerabilities stemming mainly from high private debt but also from relatively high public debt.

Despite the challenging economic environment, Cyprus enjoyed a positive market perception and advantageous financing conditions mainly thanks to the ECB's monetary policy measures, and also the Next Generation EU programme. In this framework, Cyprus undertook a liability management operation fully substituting its IMF loan with market financing. Furthermore, Cyprus tapped the markets extensively in 2020 with favourable outcomes and yields broadly in line with euro area developments. As a result, the government built up a large cash buffer minimising liquidity risks for 2020; more than half the increase in the public debt-to-GDP ratio between end-2019 and end-2020 was due to a sizeable strengthening of the cash buffer.

Due to joint efforts by authorities and banks, NPLs declined substantially from their peak at the beginning of 2015. The NPL ratio remains in double-digit territory and the pandemic crisis could delay plans for further reductions. The loan payment moratoria have shielded banks' balance sheets from new NPLs, although loan-loss provisions are already undermining results. To facilitate NPL workout and minimise the impact on banks' capital, secondary market prices of NPLs need to be maximised, which requires a predictable and efficient contract enforcement procedure. New lending has been subdued, driven by banks' capital constraints and the lack of a public guarantee scheme.

Under its Early Warning System, the ESM monitors risks to its loan service payments. The economic outlook for the Cypriot economy depends on the duration of the pandemic and continued policy support. A persistent health crisis weighing on external and domestic demand would threaten businesses and employment, particularly in the tourism sector. A premature end to public support schemes could lead to rising bankruptcies and unemployment. In addition, elevated household and corporate debt pose vulnerabilities to the economy given Cyprus' high NPL ratios. The implementation of envisaged reforms in the areas of local government, justice, and public administration would invigorate Cyprus' economic potential.

Portugal

EFSF

The Covid-19 pandemic and the ensuing containment measures undermined private consumption and investment, leading to a sharp economic contraction in 2020. The trade deficit widened as imports outstripped exports. Automatic stabilisers and the discretionary pandemic-related fiscal effort produced a substantial deficit in 2020. Bond market liquidity remained adequate, and volatility decreased. Market access conditions remained very favourable and bond yields declined owing to strong ECB support. The pandemic has halted the banking sector's recovery and dampened profitability metrics, although the loan moratoria have served as a buffer.

GDP declined by 7.6% in 2020 after growing by 2.5% in 2019, driven by a sharp drop in private consumption and net exports resulting from increased containment measures and uncertainty related to the pandemic. The domestic economy suffered from weaker exports as tourism activity ebbed. After a long period of favourable labour market developments, the unemployment rate increased, peaking at 8.1% in August, before falling back again to 6.9% in December as government support measures prompted a short-term, post-lockdown recovery. The rate ended the year slightly above pre-pandemic times but well below that of the global financial crisis.

The 2020 general government primary balance deteriorated to a deficit of 2.8% of GDP from a 3% of GDP surplus in 2019, in the wake of the pandemic response. Both lower revenue and substantially higher primary spending drove the primary deficit. Public debt increased sharply to 133.6% of GDP from 117% of GDP in 2019, pushed by the Covid-19 crisis.

Despite market turbulence in March, Portugal's market access remained uninterrupted, partly supported by the ECB's monetary policy measures and the Next Generation EU programme which helped stabilise markets. The Portuguese Treasury and Debt Management Agency's gross bond issuance reached €29.9 billion (including bond exchange operations). This translated into a net issuance of €19.4 billion, offset by the ECB's net purchases. Against this backdrop, Portugal's 10-year government bond yield declined to zero at end-2020 from 0.4% at end-2019.

Portugal also maintained its investment grade rating from major credit rating agencies. Fitch and S&P reversed the positive outlook back to stable in April, but Moody's maintained the positive outlook throughout 2020. DBRS maintained the country's rating unchanged at BBB (High) with a stable outlook, the highest level among the four major rating agencies.

The extensive use of government support measures and supervisory forbearance, and the large share of loans under moratoria especially for non-financial corporations, as well as continued efforts to decrease the NPL stock, narrowed the NPL ratio to 4.9% and widened the CET1 ratio to 15.4% in the fourth quarter of 2020, from 6.2% and 14.3%, respectively, in 2019's fourth quarter. However, bank profitability faces challenges from the build-up of loss provisions, and the return on equity was only 0.5% in the fourth quarter of 2020, down from 4.9% in 2019. Going forward, banks will need to cope with a difficult operating environment. The Portuguese financial system has not yet experienced the wave of domestic bank consolidation seen in other euro area countries.

Under its Early Warning System, the ESM monitors risks to its loan service payments. Portugal's high public debt burden remains an important vulnerability. Public debt swelled to a historic high due to the pandemic crisis but is expected to gradually decline over the medium-term as the economy recovers, though weaker growth and possible scarring effects could hinder the pace of debt reduction.

Regional Financing Arrangements strengthen cooperation, exchanges on pandemic

As the rescue fund for the euro area and one of the world's youngest international financial institutions, the ESM is deeply committed to promoting global financial stability together with its fellow regional crisis fighters, the RFAs. Regular dialogue and joint initiatives with ESM's global peers serve to deepen interinstitutional ties and offer mutually enriching learning opportunities to hone crisis prevention and crisis management skills. In addition, close cooperation between the RFAs and the global lender of last resort, the IMF, is key to strengthening the global financial safety net (GFSN). A multilateral framework constructed by the ESM and fellow RFAs facilitates these valuable institutional interactions.

With the onset of the coronavirus pandemic, the ESM spearheaded the use of the RFA–IMF network to exchange information on crisis-related developments and to contribute to a more efficient mobilisation of expertise and resources available throughout the GFSN. In April 2020, RFA leaders and the IMF Managing Director discussed the global and regional crisis responses. They committed to working together closely to protect the most vulnerable people and countries. In June, the RFAs' and IMF's chief economists met virtually to share their assessments of the rapidly changing economic situation, underscoring the global contraction. An IMF webinar for RFA staff followed a few days later, to broaden the staff's understanding of the IMF's crisis response strategy and reveal how RFA and IMF lending instruments could complement one another.

In late June the ESM, on behalf of the RFAs, updated the G20 International Financial Architecture Working Group, dedicated to enhancing stability and cohesion of the international financial system, on the RFAs' recent actions and the various initiatives between the IMF and RFAs during these exceptionally challenging times.

An intense year of collaboration ended with the organisation of the two annual RFA flagship events. During the 5th RFA High-level Dialogue, held virtually in October 2020, the heads of RFAs and the IMF's Managing Director emphasised that close cooperation between the IMF and RFAs will remain indispensable in promoting a sustainable recovery. In line with this collaborative spirit, RFA leaders agreed to launch a new joint staff study to compare Covid-19 responses across regions, including reflections on interinstitutional cooperation during the pandemic. Finally, the joint RFA Research Seminar in December made clear that 'building back better together' and paving the way for post-pandemic financial stability will require international cooperation to face challenges like rising debt levels. ESM management and staff are dedicated to working closely with ESM's strategic partners towards this goal.

Asset and Liability Management and Financial Structuring

- Asset Liability Management (ALM) and Financial Structuring conducts analyses and tests to ensure the Pandemic Crisis Support credit line functions efficiently.
- The team also supports the ESM's broadened mandate by overseeing its balance sheet, and specifically any risks to it stemming from the use of the SRF backstop.
- The team contributes to the automation of key operational processes.

ALM and Financial Structuring's role is to measure, monitor, and manage liquidity, currency, and interest rate mismatches between assets and liabilities that may arise from the execution of the ESM and EFSF mandate. Financial structuring, interest rate modelling, simulation, and scenario analysis covering all balance sheet risks are another major part of the team's work.

Effective as of 1 May 2020, the Lending team split off from ALM, which was, as a result, renamed ALM and Financial Structuring to better reflect its core activities. See more information in Lending.

The ALM and Financial Structuring division contributed in 2020 to setting up the Pandemic Crisis Support credit line, conducting detailed analysis and testing of the facility should a country wish to take up this new credit line.

The team also contributed to discussions on the ESM backstop to the SRF by highlighting all balance sheet risks associated with the provision of liquidity in the banking crisis resolution framework.

Beyond these new mandate-related preparations, the ALM and Financial Structuring division focused on overseeing the entire ESM/EFSF balance sheet, including the analysis and management of the liquidity, currency, and interest rate risks. The team also continued to work on debt portfolio analysis to forecast future variability of debt interest cost. Additionally, the team enhanced efficiency and data management by furthering the automation of operational processes, which is useful when conducting simulations, analyses, and reporting. The team worked with the Funding and Investor Relations division to create synergies from a liquidity management perspective.

Lending

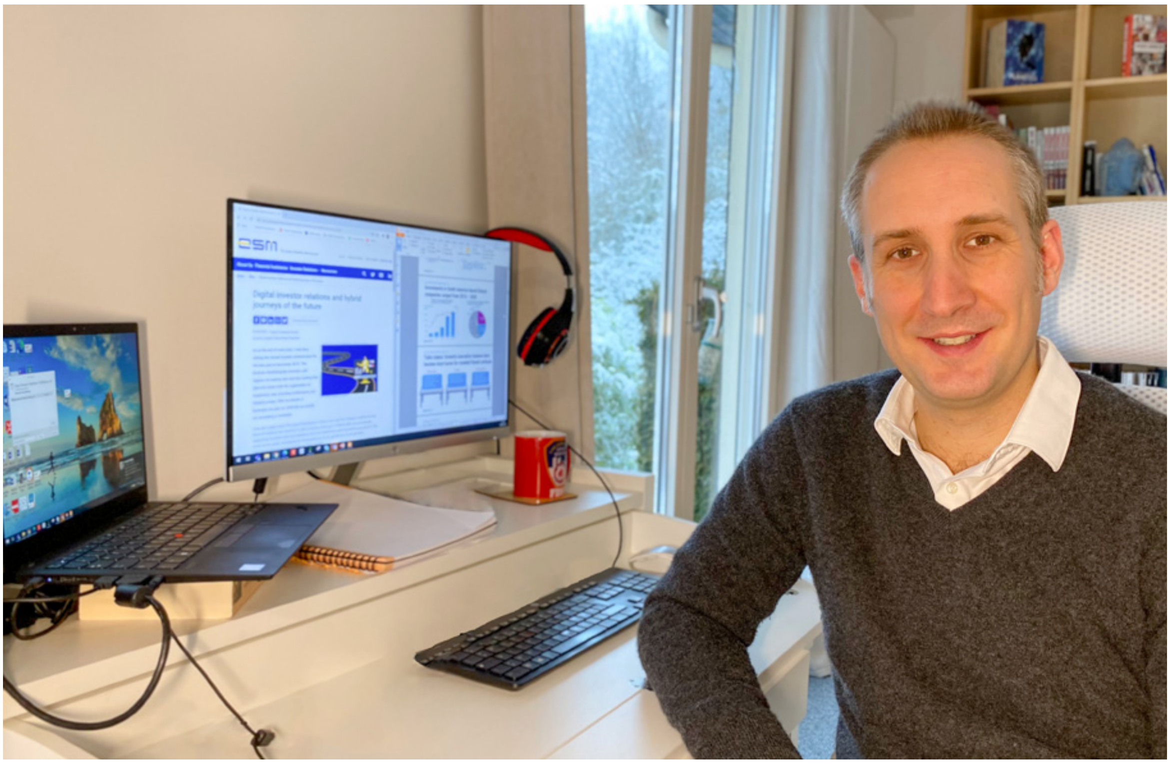
- ESM designs terms and procedures to ready Pandemic Crisis Support credit line.
- Lending team joins new Economic Risk Analysis division to marry operations with monitoring.

In 2020, the ESM focused on readying the Pandemic Crisis Support credit line for use and on preparing for the possible early introduction of the SRF common backstop. It also devoted resources to improving operational processes, such as for invoicing, with an aim to reduce manual work and related operational risks.

To ensure that the Pandemic Crisis Support instrument is immediately available if needed, the Lending team collaborated with colleagues across the institution to design the instrument-specific financial terms, loan documentation, and internal processes necessary to respond swiftly to any incoming request. So far, no ESM Member has requested the Pandemic Crisis Support credit line.

Effective 1 May, the Lending team joined the newly created Economic Risk Analysis division, to facilitate the coordination of the team's operational and policy tasks with the division's programme and country monitoring work.

Favourable ESM/EFSF lending terms have generated budgetary savings for former programme countries. The ESM estimates these savings by comparing the lending rates on ESM/EFSF loans with the interest rates that these countries would have faced had they covered the disbursed amounts in the market. These computations were based on the spread between the estimated 10-year market rates for each programme country at the time of disbursements and the actual ESM/EFSF cost.



Cumulative estimated budget savings are significant for all former programme countries. Up until 2019, cumulative estimated budget savings amounted to 2.3% of GDP for Ireland, 43.2% of GDP for Greece, including the deferral of some of the interest, 1.2% of GDP for Spain, 11.9% of GDP for Cyprus, and 5.3% of GDP for Portugal (Table 1).

Table 1
Cumulative estimated savings for all former programme countries
(in % of GDP)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	Total
Ireland	0.1	0.3	0.3	0.3	0.3	0.3	0.3	0.2	0.2	2.3
Greece		1.6	4.1	5.0	5.2	6.2	6.6	7.0	7.5	43.2
Greece – EFSF		1.6	3.7	4.3	4.4	4.7	5.0	5.0	5.2	33.9
Deferred interest			0.4	0.7	0.7	0.7	0.6	0.7	0.7	4.5
Greece – ESM					0.2	0.8	1.1	1.3	1.55	5.0
Spain			0.2	0.2	0.2	0.2	0.2	0.1	0.1	1.2
Cyprus			0.7	1.6	1.9	2.0	1.9	1.9	1.9	11.9
Portugal	0.1	0.4	0.6	0.7	0.7	0.7	0.7	0.7	0.7	5.3

Source: ESM

Funding and Investor Relations

- The ESM/EFSF achieves its annual funding target with the issue of its final 2020 bond tap in November, despite elevated debt issuance from EU sovereigns and institutions seeking to alleviate the financial distress caused by the Covid-19 pandemic.
- ESM develops a social bond framework for potential new issuance under its Pandemic Crisis Support credit line.
- Central bank participation in ESM/EFSF issuance jumps to 44% in 2020 from 33% in 2019.
- ESM issues smaller-sized bonds more frequently.

ESM issues smaller-sized bonds more frequently

The combined funding target for 2020 was €30.5 billion, comprising €11 billion for the ESM and €19.5 billion for the EFSF.

As every year, the ESM issued bonds in a range of maturities (Figure 11). Given a smaller funding programme than in previous years, the ESM focused its strategy on issuing benchmark transactions of €1.5 billion to €3 billion in size and tapping outstanding lines. Issuing smaller benchmark bonds enabled the ESM to come to the market more often and remain a frequent issuer, keeping it at the forefront of investors' minds. By having a large number of bonds in core maturities, the ESM maintained a full yield curve with many reference points, an important consideration for global investors. The ESM also continued to reopen existing bonds to increase their liquidity.

In addition, the ESM stepped up its use of intraday execution in 2020. Announcing and executing a bond transaction on the same day, which reduces the risk of market shifts hampering the issue, proved beneficial in a volatile market environment with an abundance of competing supply from other issuers. Since the ESM announces its issuance weeks in advance for each quarter, investors know when an issuance is likely and are primed to participate.

The ESM started its 2020 bond issuance with a new 3-year bond priced on 10 February raising €3 billion, and followed that with a new 10-year bond that raised a further €2 billion later in the month. The only transaction in the second quarter was the reopening of the ESM September 2028 bond for €1.5 billion. In the third quarter, the ESM returned to the dollar market with a 3 billion 5-year US dollar bond. On 19 October, the ESM completed its annual funding target with a €2 billion 4-year bond.

All euro bonds were issued at negative yields. The dollar bond was also negative when swapped back to euros from dollars.

ESM introduces 12-month bill

The ESM bill programme continued to attract investors in 2020 and all bill auctions were comfortably oversubscribed. The highlight of the 2020 short-term funding programme was the introduction of a new 12-month bill in April. This new line not only complements the existing 3- and 6-month offering but also provides an additional investment opportunity for short-term investors. It further equipped the ESM with an extra tool and higher frequency for raising short-term liquidity.

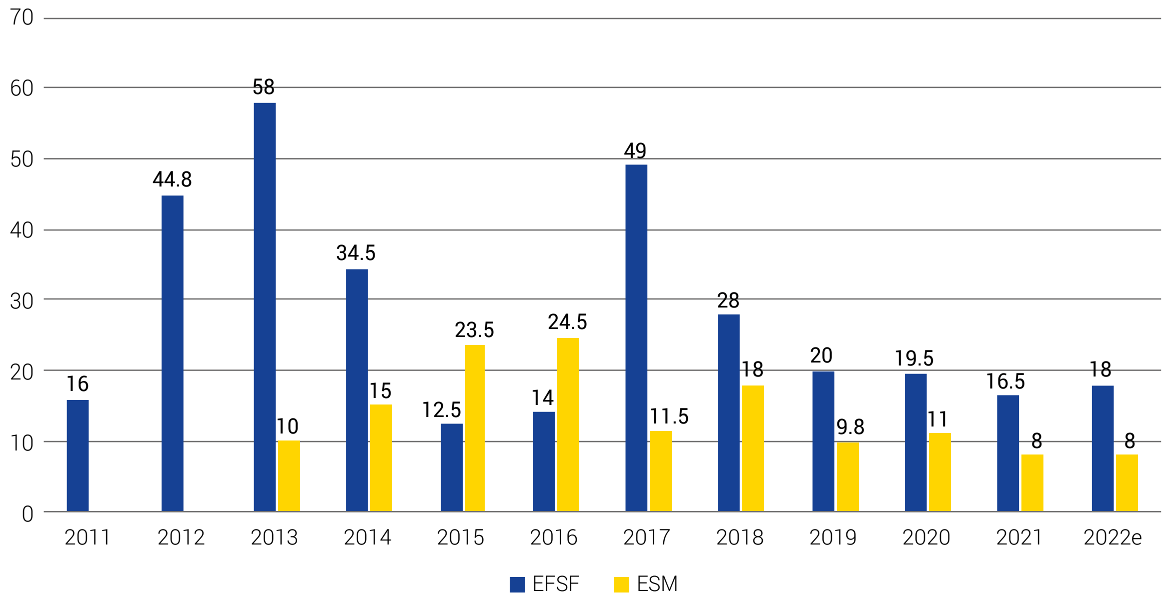
In total, the ESM issued €60.3 billion in bills. The lowest average yield was -0.6644% for the last transaction of the year – the 3-month bill issued on 1 December. Despite the low yield, the bill was more than six times oversubscribed. The highest yield of the year was the first 12-month bill issued at -0.318% on 15 April.

Investor Relations switches to virtual platforms

The Covid-19 crisis initially disrupted Investor Relations activity but the ESM adapted quickly, moving to the new online environment. Transparency and communication are key to the ESM's Investor Relations strategy, so it was crucial to maintain relationships with investors. Though the global lockdown prompted the swift cancellation in March of a busy schedule of investor meetings, conferences and events, video and conference calls replaced physical meetings from April onwards, when virtual roadshows became the new normal. The ESM held 60 bilateral calls with key investors throughout the year and participated in 23 virtual conferences as speakers and panellists.

On 20 May, the Managing Director outlined to investors the scope and potential effect on the ESM

Figure 11
EFSF and ESM bond issuance over the years
(in € billion)



Note: 2022e = estimate of 2022.

Source: ESM

funding programme of the newly approved Pandemic Crisis Support tool. He explained via conference call that funds raised under the Pandemic Crisis Support tool could also be issued as social bonds. The ESM developed a social bond framework built around the International Capital Market Association's (ICMA) social bond principles. Any social bonds the ESM issues will have the same rating as conventional bonds and will be listed on the Luxembourg Green Exchange.

The ESM held two flagship events in 2020. In July, a virtual conference on capital markets looked at macroeconomic themes, as well as the role of sustainable finance in the economic recovery, among others. The two-day conference, open to investors worldwide and reserve managers at central banks and official institutions, was organised by the ESM and the EIB.

Following the success of the July conference, the ESM held a second online event in October to present to international investors the united and coordinated action taken by Europe to tackle the Covid-19 crisis and the subsequent impact on the funding programmes of the EU, EIB, and ESM. More than 400 investors and market participants worldwide attended the event.

Central bank participation in ESM issuance grows

Looking at the investor breakdown in 2020, the participation of the global central bank community rose to 44% from 33% in 2019 (Figure 12). ESM issuances focused on the shorter end of the yield curve with a maximum maturity of 10 years and particularly with 3-, 4- and 5-year bonds issued, the preferred investment opportunities for central banks, which played a decisive role in this trend. However, global investors' positive view of Europe witnessed during investor meetings over the course of the year and the increasing importance of the euro as an international currency were also key (Figure 13).

ESM steps up virtual connectivity on key topics

ESM Managing Director Klaus Regling (second from right), EIB President Werner Hoyer (far right), and ESM Chief Financial Office Kalin Anev Janse (far left) present Europe's response to Covid-19 and the impact on markets and funding needs to investors in an 8 October 2020 video conference. ESM Senior Economic Press Officer Juliana Dahl (second from left) moderates.

ESM Chief Financial Officer Kalin Anev Janse (top left) leads a spirited discussion with EU policymakers, institutional and business leaders, and investors at a July virtual conference on capital markets. Top row, from left to right: Janse; Elke König, Chair of the Single Resolution Board; Lorenzo Bini Smaghi, Chairman of Société Générale. Bottom row, from left to right: Thomas Wieser, Chair of the High-Level Forum on capital markets union, European Commission; Corien Wortmann-Kool, Board Chair of ABP Pension Fund; Peter Praet, former Executive Board Member and Chief Economist of the European Central Bank.

ESM earns new high ratings, gains new investors

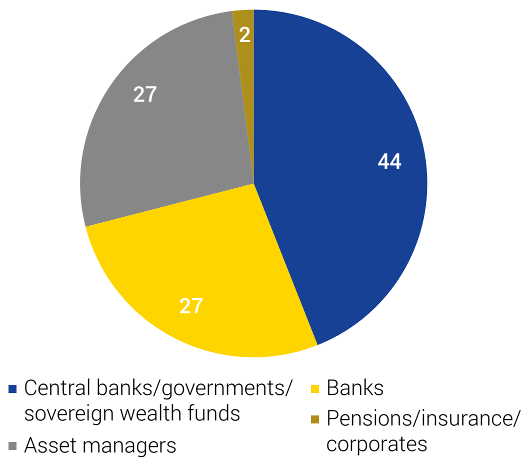
S&P rating agency assigned the ESM a rating for the first time in August, an important 2020 event that the investor community welcomed as a positive signal. The S&P assignment of a AAA long-term rating and A-1+ short-term rating meant that the ESM saw new investors in both bonds and bills.

The ESM and EFSF attracted 58 new investors in 2020. Of these new investors, six came from the ESM dollar bond, underpinning the importance of diversification in dollars.

Funding outlook 2021

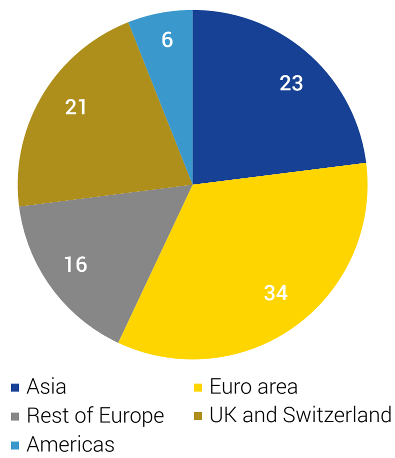
The combined funding target for the EFSF and ESM for 2021 is €24.5 billion comprising €16.5 billion for the EFSF and €8 billion for the ESM.

Figure 12
Investor participation in ESM syndicated bonds in 2020, by investor type
(in %)



Source: ESM

Figure 13
Investor participation in ESM syndicated bonds in 2020, by geography
(in %)



Source: ESM

ESM receives new AAA ratings

S&P assigned ratings to the ESM for the first time in August 2020: a long-term AAA rating, a short-term A-1+ rating, and a stable outlook. S&P cited the ESM's extremely strong enterprise risk and financial risk profiles for the decision. The top ratings underline the ESM's uniquely robust capital structure and strong shareholder base, consisting of the 19 euro area member states. The ESM also has very high long-term ratings by Fitch (AAA) and Moody's (Aa1).

The ESM received an unsolicited AAA long-term rating by Scope Ratings (Scope) in May 2020. Scope highlighted ESM's highly rated key shareholders, substantial capital position, very high liquidity buffers, and excellent capital markets' access. The ESM has an additional unsolicited AAA long-term rating from DBRS Morningstar.

Table 2
ESM ratings

S&P	Long-term rating	AAA
	Short-term rating	A-1+
	Rating outlook	Stable
Fitch	Long-term rating	AAA
	Short-term rating	F1+
	Rating outlook	Stable
Moody's	Long-term rating	Aa1
	Short-term rating	P-1
	Rating outlook	Stable
DBRS Morningstar	Long-term rating	AAA
	Short-term rating	R-1 (high)
	Rating outlook	Stable
Scope	Long-term rating	AAA
	Short-term rating	S-1+
	Rating outlook	Stable

Notes: Scope and DBRS Morningstar ratings are unsolicited. S&P and Scope assigned new AAA ratings in 2020.

Sources: The rating agencies named, compiled by the ESM

Investment and Treasury

- ESM records positive performance on its paid-in capital and outperforms its benchmarks.
- ESM accelerates the build-up of its hold-to-maturity tranche.
- ESM introduces money market futures to manage interest rate risk.
- ESM signs UN-PRI and significantly increases its ESG presence.

Paid-in capital records a positive performance in 2020

The ESM's paid-in capital stood at €80.5 billion at the end of 2020, and will total €80.8 billion in 2027 when all instalments from existing ESM Members have been received. The capital is invested in three tranches with different investment horizons, liquidity objectives, and financial valuation: the short-term and medium-/long-term tranches, whose assets are marked to market, and a hold-to-maturity tranche, valued on an amortised cost basis.

In 2020, the ESM's marked-to-market portfolio recorded a positive return of 0.40%. The assets appreciated as 10-year yields declined by a further 40 basis points into negative territory for Germany and by about 50 basis points for public agencies and supranationals.

The ESM reacted to changes in market conditions throughout the year. The ESM positioned itself for a more accommodative monetary policy in Europe by increasing its interest rate exposure early on and focusing its investments on spread products. With the introduction of the ECB's Pandemic Emergency Purchase Programme and other policies to address the Covid-19 crisis, these spread products outperformed. The ESM also favoured investments in longer maturities and benefitted from the 15 basis point curve flattening in the 5-to-10-year sector. These investments led the paid-in capital cash holdings, which remained elevated as they continued to offer yields significantly above eligible short-term securities, to decrease to €42 billion from €54 billion a year earlier.

The paid-in capital's credit quality remains high, with 92% (Figure 14) held with Eurosystem central banks or invested in assets rated AA- or higher. The share of public agency, sub-sovereign, supranational, and covered bonds climbed to 43% from 30% in 2019 (Figure 15), while non-euro denominated assets, hedged into euros, rose by €1 billion to a €9 billion equivalent. The ESM's non-euro assets – US dollar, British pound, Japanese yen, Swiss franc, Canadian dollar, Australian dollar, and Swedish krona – served to both increase returns and diversify credit exposure.

As a result, the annual performance of the marked-to-market portfolios was 56 basis points higher than the long-term benchmarks, taking the outperformance since inception to 21 basis points per year. The benchmarks, which the ESM Board Risk Committee (BRC) reviews annually, consist of indices of AAA/AA rated euro area government and supranational bonds and reflect the objectives and constraints defined in the ESM's investment guidelines.

The paid-in capital realised a small profit of €7.6 million for the year, as the positive income from security sales more than offset the negative interest on cash and securities. This is unlikely to be repeated in the next few years. If yields remain unchanged or move up, the value of the investments would fall, due to negative yields and potentially declining bond prices. Even if yields were to continue to decline slightly, the impact of negative yields would prevail over the positive price change. As in previous years, the ESM received compensation of negative interest paid on the ESM's Eurosystem cash deposits in 2019 in the amount of €235.7 million. To ensure that the negative interest environment would not erode ESM's capital, France, Germany, Italy (since November 2019) and the Netherlands (since February 2020), have agreed, as a temporary solution and under certain conditions, to return the negative interest payments on ESM's capital deposited with their respective national central banks. The accumulated profit on the ESM's capital since inception is €1.629 billion, including €685.2 million extraordinary income from negative interest compensation received through the end of 2020.

ESM increases longer maturity investments to reinforce its long-term financial strength

In 2020, the ESM continued building up its hold-to-maturity tranche invested in longer maturities to support the ESM's long-term financial strength. This portfolio is invested across asset classes and issuers and focuses on highly rated eligible issuers, to ensure long-term credit quality and diversification. The purchase pace accelerated in the first half of 2020, when yields and spreads temporarily increased with Covid-19 forcing strict lockdowns across Europe. As of year-end, the portfolio reached €5.8 billion invested in 7- to 20-year maturities. The ESM intends to continue building up this portfolio progressively over time.

ESM introduces money market futures to manage interest rate risk

The ESM, which deploys derivatives to manage or hedge risks, has expanded its use of these instruments by starting to use money market futures contracts in November 2020. These contracts enable the ESM to adjust the short-term interest rate exposure of the portfolios, when needed. The activity remains limited at this stage.

Given the UK's departure from the EU, the ESM has continued to adjust its group of eligible counterparties. The ESM transferred all its contracts for bilateral derivatives investment operations to euro area counterparties from London-based counterparties and novated the existing positions. In those few cases where EU-based entities were not available, the ESM closed its positions.

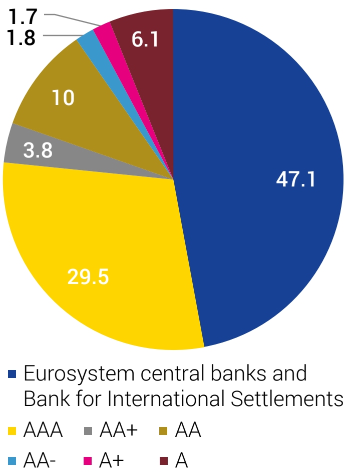
ESM increases significantly its ESG presence

In February 2020, the ESM signed the UN-PRI, a leading and reputable network for responsible investment supported by the United Nations. It offers a credible and robust framework, yet with enough flexibility to implement the principles tailored to the mandate of the investor. This participation allows the ESM to publicly demonstrate its commitment to responsible investment while still pursuing core investment objectives, namely creditworthiness, liquidity, and return. The ESM intends to further integrate ESG criteria into its investment process and support European initiatives in this area.

In 2020, entities such as governments, public agencies, and supranationals with significant social and environmental contributions accounted for 76% of the €45 billion of the ESM's invested capital (excluding cash), an increase of seven percentage points over 2019. Of these overall 2020 investments, more than €4.5 billion have a targeted purpose such as the financing of health care, social housing, or environmental projects, more than quadruple the end-2019 total. The ESM purchased €2 billion in social and pandemic bonds, an important funding source for fighting the consequences of Covid-19, and more than €1 billion in green and sustainability bonds.

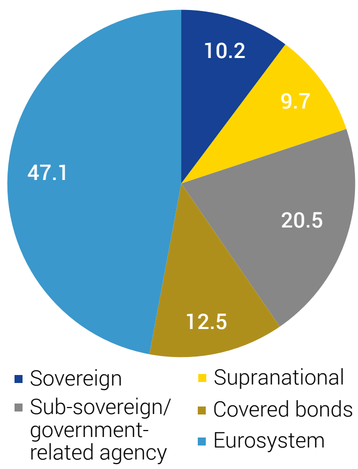
The ESM has increasingly engaged with issuers and peers on their ESG practices, in particular by taking part in a virtual conference organised by the ESM with 20 international financial institutions. The ESM is also participating, as an observer, in the European Commission Platform on Sustainable Finance, which assists the Commission in further developing the EU taxonomy. For more information, see ESG at the ESM.

Figure 14
Ratings distribution of investments
(in %)



Source: ESM

Figure 15
Asset class distribution of investments
(in %)



Source: ESM

Risk Management

- ESM further ensures risks are managed appropriately given rising threats from the global pandemic, and heightened uncertainty, for example, from the end of the Brexit transition period.
- Risk adds an information security function, and improves cyber risk measures.
- Risk Management delivers increased automation and analytical capabilities in risk management and portfolio performance and optimisation and, with other divisions, enhances governance on stress testing.
- Risk increasingly emphasises ESG considerations.

Monitoring 2020's unique challenges and risks

The Risk Management division is responsible for the independent, institution-wide management of financial and non-financial risks inherent to the ESM's mandate and operational activities. In 2020, the ESM and its Members also faced heightened risks brought on by the Covid-19 pandemic and uncertainty about the future of EU relations with the UK after the latter departed the EU.

The Risk division reviewed its risk framework to ensure it stood robust enough to accommodate any additional risks arising from the use of the ESM's new Pandemic Crisis Support credit line.

With the pandemic accelerating in March and April 2020, credit rating agencies took an exceptionally high number of negative rating actions, reflecting their revised assessment of heightened credit risks. At the start of the pandemic, the ESM enhanced its analysis of counterparties and implemented closer monitoring of those more likely to face negative credit rating revisions. The team also simulated medium-term scenarios of how credit rating agencies might adjust the ratings of counterparties in response to the pandemic. The ESM regularly submitted counterparty credit exposures and assessments to the Internal Risk Committee (IRC) and the BRC for review.

The ESM was well equipped to handle the uncertainty surrounding the UK's transition out of the EU at end-2020. The ESM has taken steps since 2018 to mitigate the consequences of Brexit by reviewing UK-based counterparties, reducing exposures to these counterparties, renegotiating derivative transaction agreements, and reviewing the readiness of British service providers for the end of the transition period.

Before the general lockdown in Luxembourg, Risk performed assessments to identify and mitigate the risks connected with remote working. Risk also undertook a review of the annual Risk and Control Self-Assessment to include an assessment of Covid-related risks in business areas.

The ESM further increased the hold-to-maturity portfolio that facilitated investments in longer maturity assets with positive yields supported by prudent risk standards.

ESM boosts measures and automation; validates models

In 2020, the ESM reinforced information security and cyber risk mitigation measures. The ESM established an information security function within the Risk division to provide independent oversight and monitoring of information technology operations and other 'first line of defence' divisions managing information security. The aim was to strengthen the confidentiality, integrity, and availability of valuable or sensitive information and enhance resilience to cyber security risks. The information security function establishes risk guidelines for the ESM's information security strategy and for the design of information security controls. The function also maintains ESM's information security policy and conducts periodic reviews of user access to information.

The ESM also enhanced its cyber risk management. Cyber risk is any risk associated with financial loss, operational disruption, or damage to the reputation of the ESM resulting from a failure of its information systems or their unauthorised or erroneous use. The ESM was prepared for the pandemic-related increase in remote working as the cyber defences allow staff to work anytime, anywhere. The ESM increased staff awareness through exercises on pandemic-related cyber attacks, and began adapting the internal control framework as well as operational and reporting processes.

The ESM devotes significant resources to continuously adapting to protect against ever-changing cyber threats

In accordance with the ESM's model validation policy, Risk has undertaken an independent review of key models in 2020, and discussed the assessment and findings with the IRC and summarised them for the BRC.

Risk also increased its automation and analytical capabilities in market risk (value at risk), credit risk (potential future exposure), market liquidity risk, stress tests, and interest rate projections. The IRC validated the Governance of ESM Stress Testing used to assess the impact of extreme market shocks on the ESM's balance sheet.

Risk preserves collaboration with peers amid pandemic

Risk continued to exchange best practices with risk departments of other international financial institutions (IFIs). During the pandemic, Risk organised and participated in virtual meetings with other IFIs to exchange views and expertise on various risk topics.

ESM factors in ESG when assessing risks

ESG considerations play an increasingly important role in the ESM's internal operations and capital market activities. Risk Management considers ESG factors to the extent they influence the credit profile of counterparties when reviewing their credit risk. Risk Management identifies and assesses ESG factors during risk and control assessments with business areas, and reviews mitigation actions or controls.

Risk also contributes to ESM initiatives to bolster ESG practices and to strengthen the ESM's ESG rating. Risk initiated a review of how the ESM incorporates ESG factors in its management of risks going forward. Further development of ESG considerations in the risk management framework and in Risk's activities is planned for 2021 including to further enhance ESG factors in its risk policies, counterparty limit setting, and internal risk assessments.

ESG at the ESM

- ESM signs the UN-PRI and reports on its sustainable investing efforts.
- ESM publishes its second carbon footprint report in September 2020.
- ESM replaces single-use plastic with sustainable alternatives.
- ESM reviews its ESG webpages.

The ESM recognises that integrating ESG considerations in its market dealings as well as internal operations will ultimately encourage better and more sustainable outcomes for the societies it serves.

Throughout the year, the ESM took steps to strengthen ESG practices across the institution.

Environmental

The ESM is dedicated to protecting the environment and follows a prudent approach on environmental matters. The ESM examined and reported on the carbon footprint arising from its internal operations, publishing its second carbon footprint report in September 2020. This monitoring, measuring, and reporting of the ESM's environmental impact guides the design of measures to enhance its environmental practices and to reduce the use of natural resources and energy. This report identified positive emission trends, illustrating that the measures taken during the year to reduce the institutional carbon footprint have started to bear fruit.

During 2020, the ESM increasingly replaced non-recyclable plastic materials with sustainable alternatives in line with the ESM's 2019 pledge under the Zero Single-Use Plastic Manifesto. As a result of the ESM's environmental efforts, in October 2020 the Luxembourg government awarded the ESM a certificate on the sound treatment of energy sources and the recycling of waste for the eighth consecutive year. In February 2021, the ESM updated its Code of Conduct, expanding its ESG commitment by stating, for example, that the ESM will "continuously monitor, communicate, and limit further its environmental impact".

Social

Since the outbreak of the Covid-19 pandemic, the ESM has been part of a concerted European response to tackle the financial effects of the public health crisis. The ESM established a Pandemic Crisis Support credit line based on its ECCL, available to all euro area countries, to finance direct and indirect health care, cure, and prevention-related costs due to the Covid-19 crisis. Should a country draw upon the credit line, the ESM intends to issue social bonds, enabling the ESG investor community to allocate their funds to support the social needs of euro area member states. The ESM, therefore, developed a social bond framework compliant with ICMA's social bond principles. For more information, see Funding and Investor Relations.

The pandemic has, in addition to its broad economic repercussions, also resulted in significant adaptations to the ESM's mode of working to ensure effective implementation of its mandate, requiring the majority of staff to telework. In the updated Code of Conduct, the ESM reinforced its commitment to providing a safe and heathy work environment as well as its support for a culture of integrity, respect, accountability, and non-discrimination.

Governance

The ESM has a robust governance framework in place, which ensures strong accountability and transparency vis-à-vis its shareholders and other stakeholders. For more information, see Governance.

With regard to the wider institutional commitments to ESG, in February 2020, the ESM signed the UN-PRI, recognised as the leading global network for investors dedicated to integrating ESG considerations into their investment practices. The ESM has been embedding these criteria into its investment processes. For more information, see Investment and Treasury. The Risk Management division ensures that these efforts remain consistent with the ESM's risk management framework.

In 2020, the ESM reviewed its webpages that inform stakeholders and the public on the institution's ESG efforts, adding information on the Pandemic Crisis Support credit line and a library of ESG-related ESM publications. In addition, the ESM actively engaged with credit rating and ESG rating agencies, receiving recognition as among the best in its peer group. For more information, see our credit ratings. Moreover, the ESM actively exchanged with investors, peer institutions, and policy-makers in order to inform, shape, and enhance ESG-related goals. In 2020, the ESM participated in various public consultations on questions of sustainable finance, in autumn joining both the European Commission's Platform on Sustainable Finance as an observer and the ICMA Social Bond Working Group as a member.

Transparency and accountability

- ESM publishes new webpage with more information on its transparency measures.
- ESM conducts second evaluation, on financial assistance to Greece.
- ESM launches blog to discuss topical mandate-related issues.

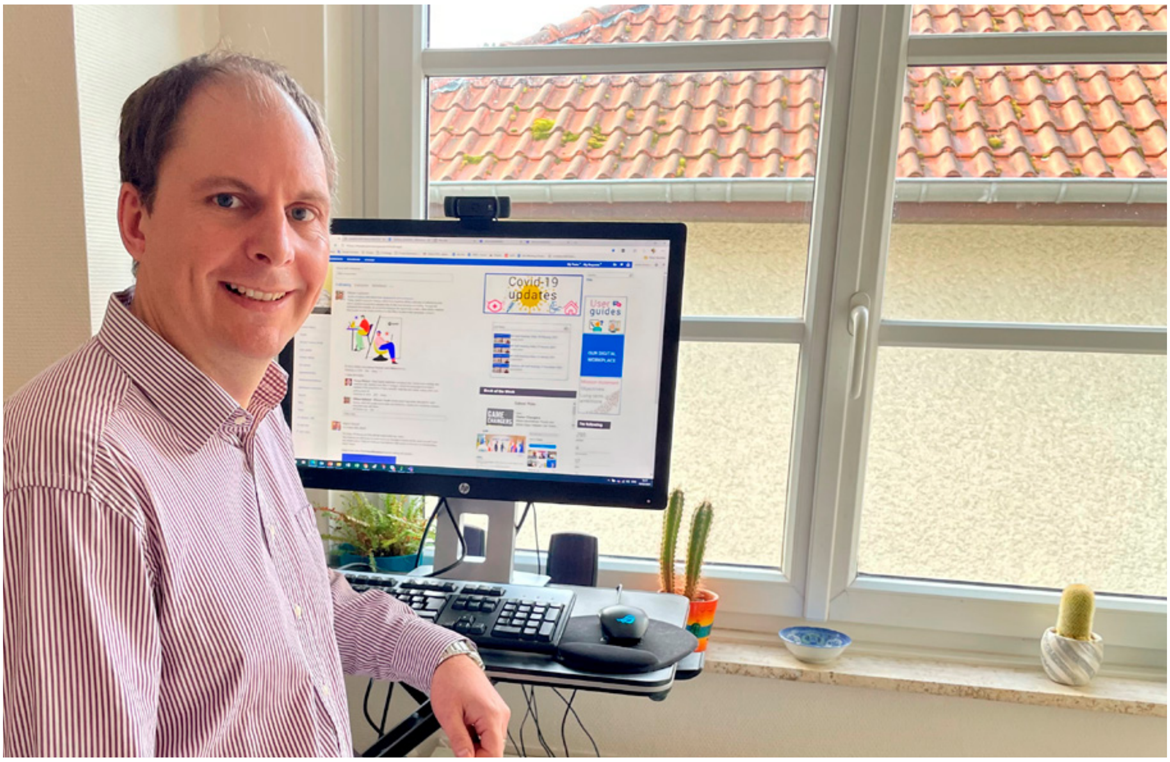
The ESM has adopted a number of measures to ensure that its stakeholders and the public have a good understanding of its mandate and work.

Since 2016, the ESM has provided extensive information on its financial assistance programmes by regularly publishing on its website programme-related BoG and BoD meeting documents, including annotated agendas and summaries of decisions. In 2020, the ESM reviewed its programme-related transparency measures and the BoG confirmed at its Annual Meeting in June that the measures remain appropriate. The ESM committed at that meeting to creating a dedicated page on its website expanding further the communication on its transparency measures.

In April 2021, the ESM published a new transparency webpage that, together with the ESM programme database launched in 2019, offers comprehensive information on the ESM's financial assistance activities and related policies and guidelines.

The ESM has also published ample information on the ESM reform process and milestones. This includes the amended ESM Treaty, signed by the ESM Members in early 2021, as well as the drafts of relevant guidelines and other documents, which will be formally approved by the ESM governing bodies once the ESM Treaty reforms are ratified by the parliaments of all 19 ESM Members.

In 2020, the ESM Managing Director and senior staff participated in various conferences, seminars, and academic gatherings virtually. Among these, the Managing Director gave a speech on fiscal rules at an interparliamentary conference in Berlin on 12 October 2020. Senior managers also spoke on several occasions on the response to the pandemic and how best to support the euro area economies. In addition, the ESM engaged in a continuous dialogue with the media, resulting in frequent interviews and television appearances, including with Bloomberg, CNBC, and the Financial Times.



In February, the ESM launched a blog, featuring regular columns from ESM senior managers and staff on ESM-related topics and the pandemic response. The ESM published 28 blogs posts during the year.

As an institution with a public mandate, the ESM has accountability embedded in its governance structure and activities. The euro area finance ministers form the ESM's BoG, its highest decision-making body, and represent ESM Members' democratically elected governments. National parliamentary procedures, required by some ESM Members before the BoG or BoD approves decisions, make the ESM indirectly accountable to national parliaments.

The BoA's extensive audit oversight also supports the ESM's accountability. The BoA's annual report to the BoG, accompanied by ESM's management comments issued in response to the report, are made available to the national parliaments and supreme audit institutions of the ESM Members, the European Parliament, and the European Court of Auditors. The report, along with the ESM's management comments, are also available to the public on the ESM website.

The ESM's evaluation activities contribute to its accountability framework. At the Annual Meeting on 11 June 2020, High-level Independent Evaluator Joaquín Almunia presented to the BoG a second evaluation report, focused on the financial assistance to Greece. The purpose of the evaluation was to assess past programme activities and draw lessons for the ESM's future work. The report acknowledged the benefit of the ESM and EFSF programmes in providing indispensable financial support to Greece following its loss of market access, and in preserving the integrity of the euro area. The first evaluation report, led by Gertrude Tumpel-Gugerell and published in 2017, considered all former ESM/EFSF programmes up to the end of June 2016.

Evaluation recommends clear strategic programme objectives

The second ESM independent evaluation report, on financial assistance to Greece, concluded that the Greek EFSF and ESM programmes successfully maintained the integrity of the euro area, stabilised Greek public finances, and strengthened institutions. The programmes reached their main objectives but suffered from weaknesses that hindered them from overcoming some key challenges.

Drawing on the Greek assessment, Independent Evaluator Joaquín Almunia made five recommendations for the ESM Governors' reflection. These were on: strategic programme objectives, guidance on programme design, governance focus on sustainable outcomes, effective programme preparation and conduct, and post-programme engagement.

The former European Commission Vice President's first recommendation emphasises the need for clearly defined strategic programme objectives to guide financial assistance and balance the need for fiscal adjustment with the risks of downward pressures on growth generating unintended consequences. The recommendation further underscores the need to adapt measures to the societal realities of each country.

The second recommendation advises that the ESM and its partners should explore ways to ensure coherent programme design and review. Programmes would have greater effect if they concentrated reforms on the most critical challenges, sequenced key reforms likely to create new economic opportunities, and strengthened safety nets before rebalancing labour costs in the economy. Expanded guidance on strategic programme objectives and clear policy frameworks would help to improve implementation.

The third and part of the fourth recommendations propose that the governing bodies clarify their commitment to sustainable outcomes beyond debt levels. According to the Independent Evaluator, the ESM should join the European Commission in negotiating and designing future programmes, and the two institutions should coordinate preparatory and subsequent programme implementation phases closely, including the assumptions underpinning diagnoses.

Parts of the fourth and fifth recommendations call for enhancing capacity to understand country vulnerabilities and to detect the potential for shock transmission between ESM Members. The evaluation found that poor institutional capacity tends to hamper the quality of reform implementation and long-term growth potential. Programme partners should therefore seek cooperative arrangements with specialised bodies to support eventual beneficiary Members' administrative and institutional capacity in areas outside the partners' own core competence.

The fifth recommendation also argues for policy advocacy to support continued good post-programme policymaking. Stronger public engagement would safeguard the sustainability of adjustment gains, which are crucial to the ESM's long-term interests as a creditor.

Mr Almunia, tasked with this exercise by the Chairperson of the ESM's BoG in February 2019, presented the evaluation report at the ESM's 11 June 2020 Annual Meeting where the ESM Governors welcomed it. The report can be found on the ESM website. This report, coupled with the 2017 evaluation led by Gertrude Tumpel-Gugerell, reinforces the ESM aims to support informed policy decision-making, increase transparency, and provide lessons learned to enhance the ESM's future crisis response.

Feedback from outreach

Following the publication of the report, Mr Almunia and the ESM evaluation team organised 13 outreach events in partnership with think tanks, universities, and other stakeholder organisations. Discussions led to feedback on the evaluation exercise itself and its resulting recommendations.

Counterparts generally considered the evaluation comprehensive and technically robust. They appreciated the additional transparency provided by four externally commissioned background discussion papers and one internal working paper, available together with the report on the ESM website, as well as the guidance from an advisory group of senior evaluators with experience at other international institutions. The ESM also published the evaluation mandate, approved by the ESM BoG, and the methodology, in a separate technical appendix.

ESM evaluation takeaways to help tailor future programmes better

Strategise
- Prioritise objectives clearly
- Derive common diagnoses based on sound technical analysis

Design and review
- Establish overarching policy frameworks
- Focus on impactful conditionality
- Design approaches to curtail unintended consequences

Promote sustainability
- Agree sustainable objectives beyond debt focus
- Increase attention on equitable long-term growth
- Employ transparent country assessments
- Assess exit strategies and create post-programme incentives

Coordinate
- Coordinate programme negotiation and review
- Refine cohesive surveillance and communication
- Support reform implementation

Engage post-programme
- Advocate policies to buttress sustained reform ownership
- Develop capacities to oversee outward contagion channels

Event participants reiterated the need for a strategic, long-term view and increased country-specific approaches to bolster popular acceptance of reforms. Several suggested that governance commitments to increasingly focused conditionality would help foster ownership from national leaders.

Another common feedback theme was the need to explore policies that preserve an even-handed allocation of the adjustment burden across society, and strengthen efforts to promote a country's capacity to implement the most crucial reforms. Ideally, they would also buttress the country's resilience to further potential shocks. Participants deemed a functioning social safety net a prerequisite for a successful internal devaluation, but also emphasised the importance of dealing with debt vulnerabilities as soon as possible and ensuring the banking system's capacity to finance the recovery.

They also recognised that the ESM operates in a highly political context. Several speakers delved into governance challenges and posited that the ESM's public image did not benefit from the euro area's initial approach to crisis resolution. They encouraged the ESM to ensure follow-up on the recommendation on the independence of staff analysis to provide sound and robust technical assessments and proposals to decision-makers.

Follow-up to the recommendations

In March 2021, the ESM followed up on the BoG call to explore ways to address the Independent Evaluator's recommendations by presenting an update on the actions taken or underway internally. Recognising that the efficient and effective partnership between the ESM and the European Commission in the provision of financial assistance is salient for the Members, Management proposed discussing a future action plan in areas of joint competence and common interest with the European Commission in 2022, to allow full consideration of the conclusions of the Commission's evaluation on the Greek programmes, the entry into force of the amended ESM Treaty, and the Memorandum of Cooperation between the ESM and the European Commission.

03 Institutional framework and organisation

The financial assistance toolkit of the ESM

The ESM has a number of financial assistance instruments at its disposal to fulfil its mission, though it has only used two to-date. The ESM grants its financial assistance in exchange for the commitment to strengthen economic and financial fundamentals in line with EU economic and fiscal coordination and surveillance frameworks.

In November 2020, the Eurogroup agreed to proceed with ESM reform. Under this agreement, precautionary credit lines will be made more effective, and the common backstop will, at its introduction, replace the direct recapitalisation instrument. The extended mandate will come into force after all 19 ESM Members ratify the revised ESM Treaty. This ratification process began with ESM Members signing the agreement amending the ESM Treaty in early 2021. For more information, see The Future of the ESM.

ESM loans

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

Conditional upon: the implementation of macroeconomic reform programmes.

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

Loans for indirect bank recapitalisation

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

Conditional upon: measures to address financial stability concerns in the banking sector.

Used: in Spain (ESM).

Precautionary credit line

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

There are two types of credit lines:

A Precautionary Conditioned Credit Line (PCCL) is available to an ESM Member whose economic and financial situation is fundamentally sound, subject to the pre-established eligibility criteria.

An Enhanced Conditions Credit Line (ECCL) is available to an ESM Member that does not comply with some of the eligibility criteria required for accessing a PCCL but whose general economic and financial situation remains sound. The ESM Pandemic Crisis Support credit line, adopted by the BoG on 15 May 2020 in response to the coronavirus crisis, is based on the ECCL and covers direct and indirect health care related costs.

Used: no.

Primary market purchases

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

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

Used: no.

Secondary market purchases

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

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

Used: no.

Direct recapitalisation of financial institutions[5]

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

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

Used: no.

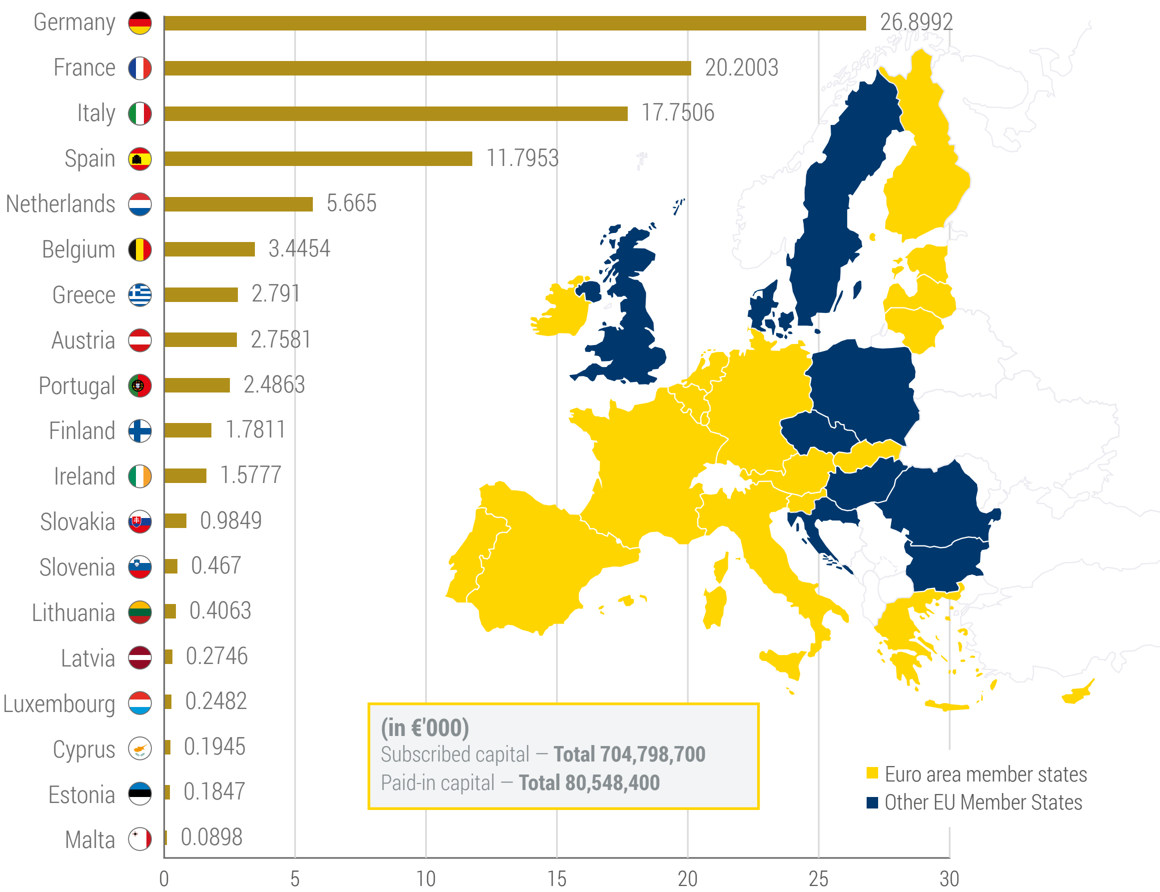
[5] Following the 30 November Eurogroup agreement to proceed with the ESM reform, the direct recapitalisation instrument will be replaced by the common backstop at the time the latter is introduced, by the beginning of 2022.

Governance

ESM shareholders

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

ESM contribution key, by ESM Member*
(in %)



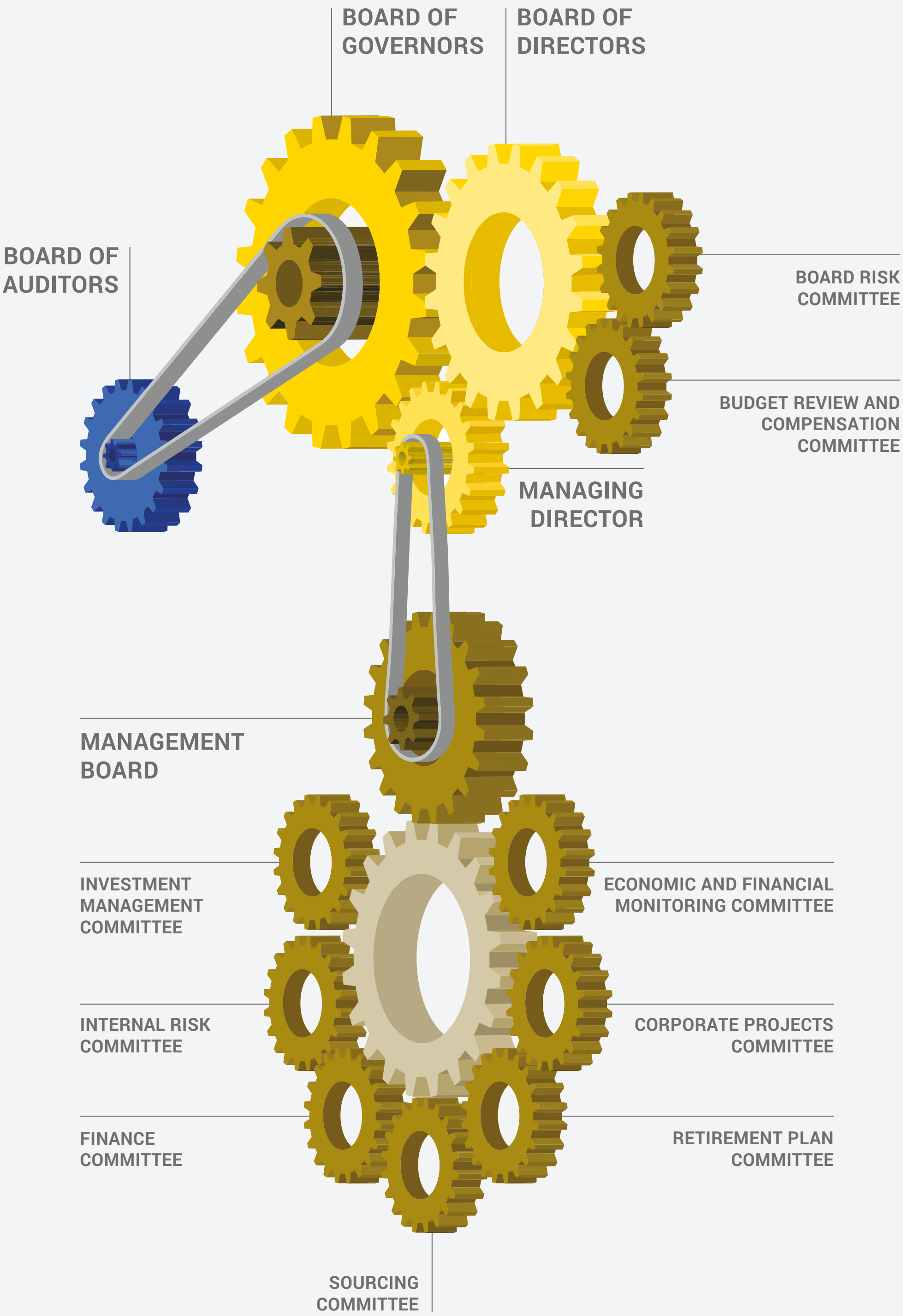
Notes: As of 23 April 2021. The accession of new ESM Members is factored into the capital key, reducing the existing ESM Members' contribution keys. Individual nominal capital subscriptions and paid-in capital amounts remain unchanged for the existing ESM Members.

* In line with Article 42 of the ESM Treaty, ESM Members with GDP per capita of less than 75% of the EU average in the year immediately preceding their ESM accession benefit from a temporary correction mechanism. During this period, the initial capital subscription of the ESM Member benefitting from the correction is lower, thus leading temporarily to a lower paid-in capital contribution. Once this period ends, the ESM Member must deposit the remaining amount. Most recently, Slovakia's temporary correction period expired on 1 January 2021, and Slovakia deposited the remaining paid-in capital contribution. One year earlier, on 15 January 2020, Malta's temporary correction period expired, and Malta deposited the remaining capital contribution. Estonia, Latvia, and Lithuania are currently benefitting from temporary corrections, the last of which concludes at the end of 2026.

Source: ESM

For more information visit our shareholder information.

Governance structure



The BoG meets at least once a year and whenever the affairs of the ESM so require (twice in 2020). The BoD also meets whenever the affairs of the ESM so require (nine times in 2020), while the Board Risk Committee and the Budget Review and Compensation Committee normally meet quarterly and additionally when required.

For more information, visit our website.

Board of Governors

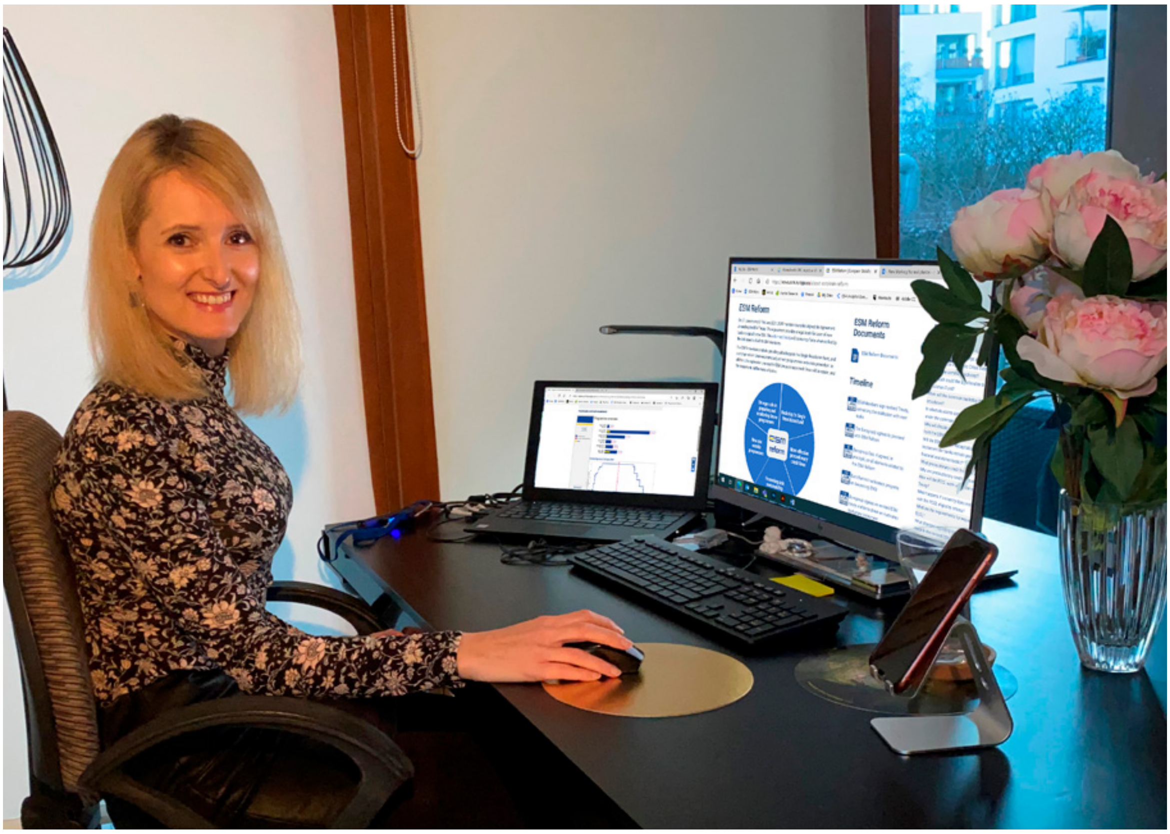
Annual Meeting of the Board of Governors

On 11 June 2020, the Board of Governors (BoG) held its eighth annual meeting in a virtual format due to the Covid-19 pandemic.

In his presentation to the BoG, the Managing Director highlighted the key achievements of the ESM during the past year, including its funding operations, investment and lending activities, and institutional developments. The High-Level Independent Evaluator, Joaquín Almunia, presented his evaluation report on the financial assistance to Greece. Following the discussion of the report, the BoG issued a statement welcoming the report's comprehensive assessment and inviting the ESM to explore follow-up work on the recommendations.

In addition, the Chairperson of the BoA addressed the Governors with regard to the BoA's annual report to the BoG as well as the BoA's report in respect of the ESM 2019 financial statements. Furthermore, the external auditor presented its report in respect of the audit of the ESM 2019 financial statements.

At this meeting, the BoG also approved the ESM 2019 Annual Report as drawn up by the ESM Managing Director.



Members of the Board of Governors

Ireland

Paschal Donohoe
Eurogroup President since 9 July 2020,
Chairperson of the Board of Governors since 17 July 2020,
Minister of Finance,
Governor since 15 June 2017

Spain

Nadia Calviño
Vice-President, Minister of Economic Affairs and Digital Transformation,
Governor since 7 June 2018

Belgium

Vincent Van Peteghem
Deputy Prime Minister, Minister of Finance and Development Cooperation,
Governor since 1 October 2020
– replacing Alexander De Croo,
Governor since 11 December 2018

France

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

Germany

Olaf Scholz
Federal Minister of Finance,
Governor since 14 March 2018

Italy

Daniele Franco
Minister of Economy and Finance,
Governor since 13 February 2021
– replacing Roberto Gaultieri,
Governor since 5 September 2019

Estonia

Keit Pentus-Rosimannus
Minister of Finance,
Governor since 26 January 2021
– replacing Martin Helme,
Governor since 29 April 2019

Cyprus

Constantinos Petrides
Minister of Finance,
Governor since 3 December 2019

Greece

Christos Staikouras
Minister of Finance,
Governor since 11 July 2019

Latvia

Jānis Reirs
Minister of Finance,
Governor since 19 February 2019

Gintarė Skaistė
Minister of Finance,
Governor since 11 December 2020
– replacing Vilius Šapoka,
Governor since 13 December 2016

Lithuania

Pierre Gramegna
Minister of Finance,
Governor since 4 December 2013

Luxembourg

Clyde Caruana
Minister of Finance and Employment,
Governor since 23 November 2020
– replacing Edward Scicluna,
Governor since 13 March 2013

Malta

Wopke Hoekstra
Minister of Finance,
Governor since 26 October 2017

Netherlands

Gernot Blümel
Minister of Finance,
Governor since 4 February 2020
– replacing Eduard Müller,
Governor since 15 August 2019

Austria

João Leão
Minister of State and Finance,
Governor since 15 June 2020
– replacing Mário Centeno,
Governor since 26 November 2015

Portugal

Andrej Šircelj
Minister of Finance,
Governor since 13 March 2020
– replacing Andrej Bertoncelj,
Governor since 13 September 2018

Slovenia

Igor Matovič
Deputy Prime Minister, Minister of Finance,
Governor since 1 April 2021
– replacing Eduard Heger,
Governor since 21 March 2020

Slovakia

Matti Vanhanen
Minister of Finance,
Governor since 17 June 2020
– replacing Katri Kulmuni,
Governor since 10 December 2019

Finland

Shareholder engagement

In October 2020, the ESM organised its seventh annual Shareholders' Day, for the first time in a virtual format due to the Covid-19 pandemic. The event once again brought together representatives from all 19 ESM Members, who work in their respective ministries of finance on ESM-related matters, as well as representatives from the European Commission, ECB, and Eurogroup Working Group Secretariat. The event focused on the current issues and latest developments in the euro area, including the European response to the pandemic, ESG considerations, the evaluation report on lessons from the financial assistance to Greece, and perceptions of the ESM among its Members. Panellists included ESM staff members, as well as representatives of partner institutions and shareholders.

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

Board of Directors

Members of the Board of Directors

CHAIR OF THE MEETINGS OF THE BOARD OF DIRECTORS

Klaus Regling
ESM Managing Director

Ireland

Gary Tobin
Assistant Secretary General, International & EU Division, Department of Finance, appointed on 8 July 2019

Belgium

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

Greece

Michael Arghyrou
Chairman of the Council of Economic Advisors, appointed on 22 July 2019

Germany

Jörg Kukies
State Secretary, Federal Ministry of Finance, appointed on 9 April 2018
– Member of the Board Risk Committee since 9 October 2020, appointed until 8 October 2023
– Member of Budget Review and Compensation Committee from 14 May 2018 until 8 October 2020

Spain

Carlos San Basilio
Secretary General of the Treasury and International Financing, Ministry of Economic Affairs and Digital Transformation, appointed on 19 June 2018
– Member of the Board Risk Committee since 9 October 2020, appointed until 8 October 2023
– Member of the Budget Review and Compensation Committee from 13 July 2018 until 8 October 2020

Estonia

Märten Ross
Deputy Secretary General for Financial Policy and External Relations, Ministry of Finance, appointed on 21 October 2013
– Member of the Board Risk Committee since 9 October 2020, appointed until 8 October 2023

France

Emmanuel Moulin
Director General of the Treasury, Ministry of Finance and Public Accounts, appointed on 9 November 2020
– Replacing Odile Renaud Basso, appointed on 30 June 2016
– Member of the Board Review and Compensation Committee since 23 November 2020, appointed until 8 October 2023

Italy

Alessandro Rivera

Director General of the Treasury, Ministry of Economy and Finance,
appointed on 27 July 2018
– Member of the Board Risk Committee since 20 September 2018, appointed until 8 October 2021

Malta

Alfred Camilleri

Permanent Secretary, Ministry for Finance and Employment,
appointed on 8 October 2012
– Member of the Budget Review and Compensation Committee since 9 October 2012, reappointed until 8 October 2022
– Chairperson of the Budget Review and Compensation Committee since 24 April 2014, reappointed until 8 October 2022

Cyprus

George Panteli

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

Netherlands

Christiaan Rebergen

Treasurer-General, Ministry of Finance,
appointed on 6 June 2018
– Member of the Budget Review and Compensation Committee since 5 September 2019, reappointed until 8 October 2022

Latvia

Līga Kļaviņa

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

Austria

Harald Waiglein

Director General for Economic Policy, Financial Markets and Customs Duties, Federal Ministry of Finance,
appointed on 8 October 2012
– Member of the Board Risk Committee since 9 October 2012, reappointed until 8 October 2022
– Chairperson of the Board Risk Committee since 8 June 2018

Lithuania

Mindaugas Liutvinskas

Vice-Minister, Ministry of Finance,
appointed on 8 January 2021
– Replacing Miglė Tuskienė, appointed on 4 March 2015

Portugal

João Nuno Mendes

Secretary of State of Finance, Ministry for Finance,
appointed on 15 June 2020
– Replacing Ricardo Mourinho Félix, appointed on 7 December 2015

Luxembourg

Nima Ahmadzadeh

Director of Economic and Fiscal Affairs, Ministry of Finance,
appointed on 26 July 2019
– Member of the Budget Review and Compensation Committee, appointed until 8 October 2021

Slovenia

Katja Lautar

Head of Office for Fiscal and Economic Policy, Ministry of Finance,
appointed on 19 February 2019

Slovakia

Peter Paluš

Head of Financial Unit at Permanent Representation of Slovakia to the European Union,
appointed on 22 February 2017
– Member of the Board Review and Compensation Committee since 9 October 2020, appointed until 8 October 2023
– Member of the Board Risk Committee from 8 February 2018 until 8 October 2020

Finland

Leena Mörttinen

Permanent Under-Secretary, Ministry of Finance,
appointed on 5 November 2020
– replacing Marketta Henriksson, appointed on 28 February 2020

Board of Auditors

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

The BoA is composed of five members appointed by the BoG in line with Article 24 of the By-Laws. New members of the BoA are appointed for a non-renewable term of three years.

In 2020, the BoA held 14 meetings. Due to the ongoing Covid-19 pandemic, 12 of these meetings took place virtually. During these meetings, the ESM management and senior staff updated the BoA on ESM activities, the decisions of the ESM governing bodies, and other relevant issues and developments. The BoA met regularly with the internal audit function, and monitored and reviewed the work of the external auditors. In addition, the Chairperson of the BoA met once with the Chairperson of the BRC, as well as with the BoD. Furthermore, the Chairperson of the BoA met with the Chairperson of the BoG and attended the Annual Meeting of the BoG to discuss the audit work, conclusions, and the reports issued by the BoA.

During the year, the BoA also concluded, with the support of subject-matter experts from the Maltese National Audit Office, its audit on ESM internal committees. In fulfilling its role, the BoA also reviewed the ESM 2020 Financial Statements.

The BoA issues two reports per financial year: an annual report on the ESM financial statements, which is included in the ESM annual report in addition to the external audit opinion, as well as a report to the BoG, which summarises its audit work, conclusions, and recommendations for the respective year. The BoA's annual report to the BoG, together with the ESM management comments in response to the report, are made available to the national parliaments and supreme audit institutions of the ESM Members, the European Parliament, as well as the European Court of Auditors. These documents are also published on the ESM website.

Members of the Board of Auditors

Baudilio Tomé Muguruza
Chairperson since 22 January 2020
Member since 17 December 2019
Appointed upon nomination by the European Court of Auditors

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

Ilias Dimitriadis
Member since 8 October 2019
Appointed upon nomination of the Supreme Audit Institution of Greece

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

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

Internal control framework

The ESM internal control framework is embedded in the ESM's daily operations and reflects the nature, complexity, and risks inherent in ESM activities. The ESM internal controls are underpinned by the three lines of defence governance model established by the BoD and are aligned with the principles of the Basel Committee's Framework for Internal Control Systems in Banking Organisations.[6]

In 2020, the *Procedure for maintenance of ESM internal control framework* was updated to provide further detail on the scope of the framework and its application by the various functions in the institution.

ENTITY-LEVEL CONTROLS

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

PROCESS-LEVEL CONTROLS

include operational controls embedded in key processes and transactions.

INFORMATION TECHNOLOGY (IT) CONTROLS

include IT general controls over the IT environment, computer operations, access to programmes and data, programme development, change management, IT security, and IT application controls embedded in ESM systems.

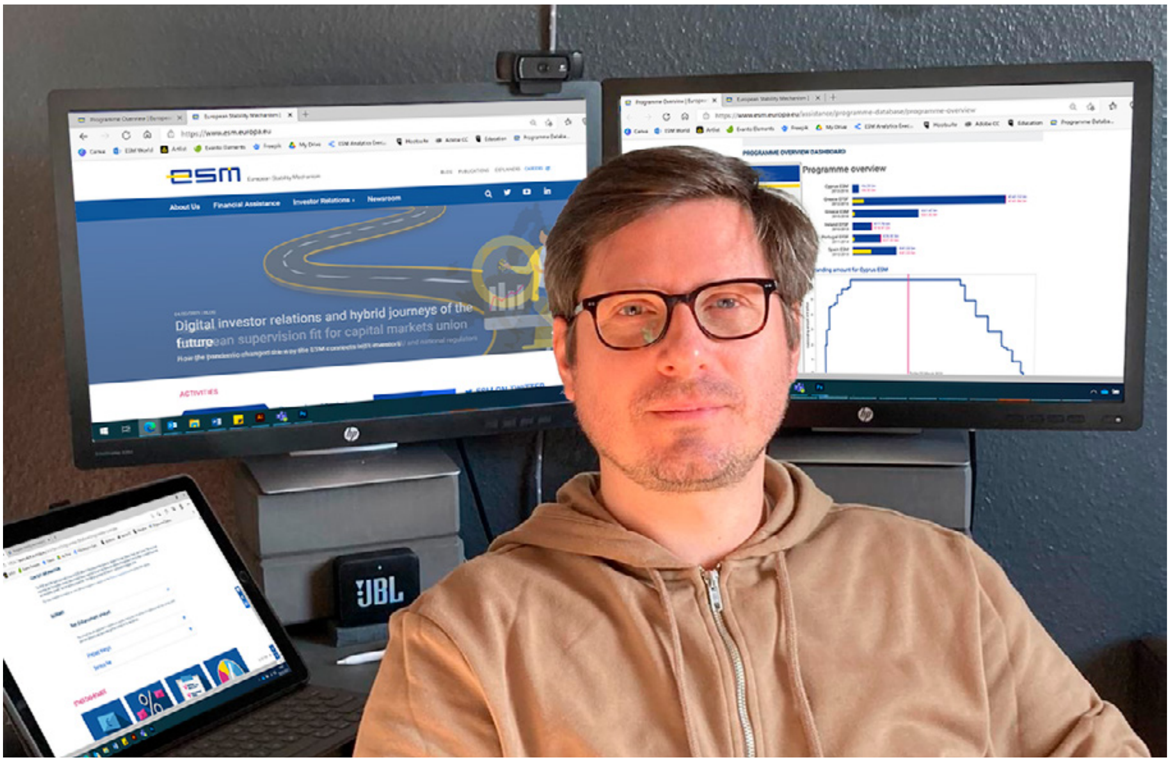
[6] Framework for Internal Control Systems in Banking Organisations, Basel Committee on Banking Supervision, Basel, September 1998.

The Managing Director, under the direction of the BoD, is responsible for the ongoing maintenance of the ESM internal control framework. Assisted by the Management Board, the Managing Director sets a strong tone at the top and oversees internal controls across all areas of the ESM. Each year, the Managing Director issues a management report on the state of internal controls to the BoD (via the Board Risk Committee) and the BoA. The report is made available also to the external auditor. The management report on internal controls as of 31 December 2020 does not indicate material or significant internal control weaknesses.

Internal audit provides an independent assurance on the established internal controls and procedures as part of the regular audit cycle. In addition, internal audit annually reviews the operation of the entity level controls and IT application controls on a rotational basis.

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

At the same time, similarly to other organisations and their auditors, we recognise that there are inherent limitations to the effectiveness of any system of internal controls, including the possibility of human error or circumvention of overriding controls. Therefore, even an effective internal control framework can provide only reasonable assurance.



ESM organisational structure

In September 2020, the ESM completed its two-year, two-step management reorganisation, ensuring that it can efficiently deliver on its new mandate. In this second stage, the ESM redistributed the retiring Chief Corporate Officer's responsibilities and ESM Secretary General Nicola Giammarioli joined the Management Board, assuming leadership of a newly created Secretary General department.

Klaus Regling
Managing Director

Christophe Frankel
Deputy Managing Director and Chief Risk Officer

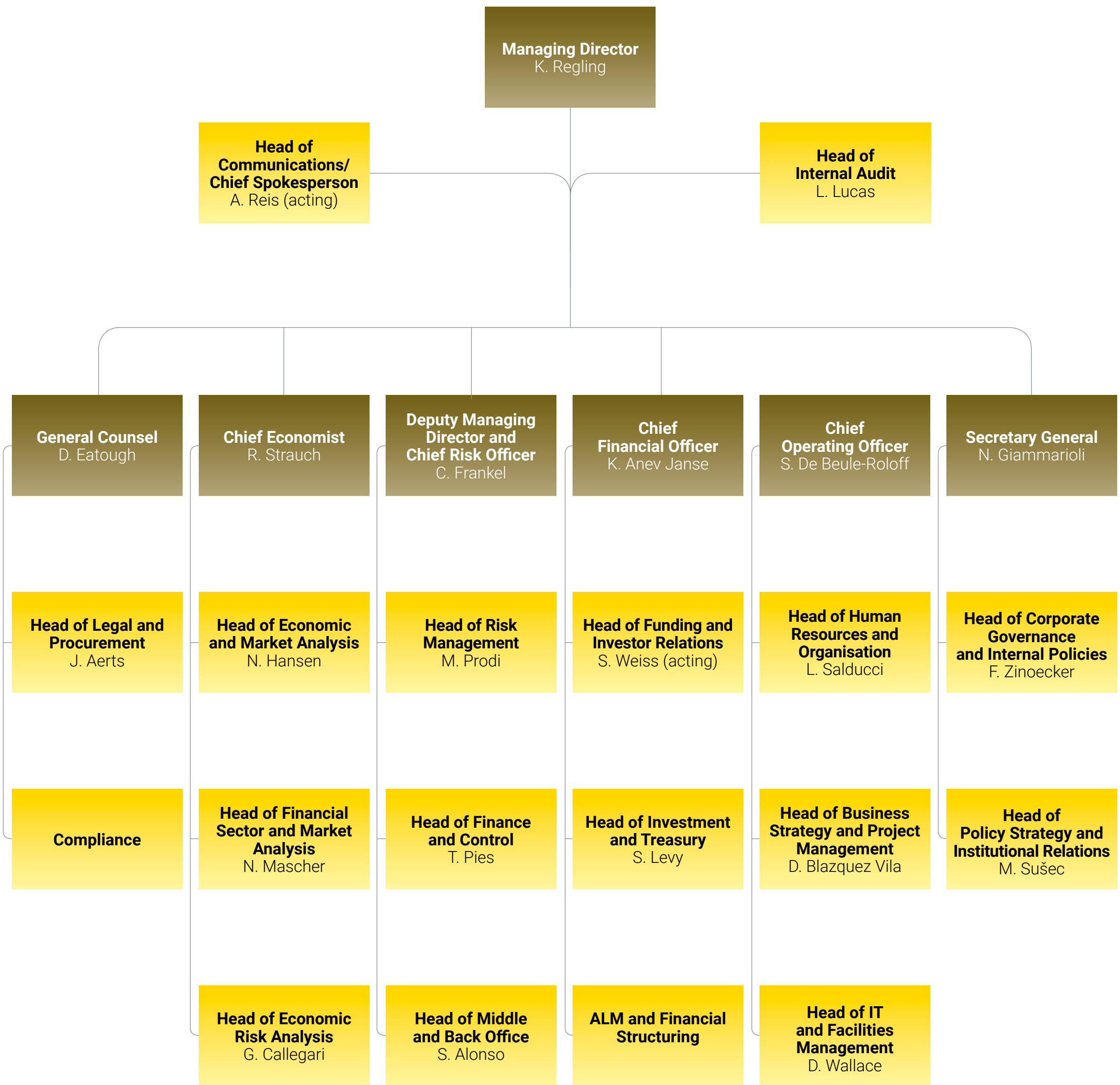
Sofie De-Beule Roloff
Chief Operating Officer

David Eatough
General Counsel

Nicola Giammarioli
Secretary General

Kalin Anev Janse
Chief Financial Officer

Rolf Strauch
Chief Economist



Member of the Management Board

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

04

Financial report

Balance sheet

As of 31 December 2020, the total ESM balance sheet was €828.6 billion. Compared to the previous year, it increased by €8.6 billion, mainly due to a €7.1 billion increase in *Debt evidenced by certificates* in relation to the rollover of maturing bonds and for funding cash collateral needs.

The €80.5 billion of paid-in capital is invested in debt securities or held in cash. The *Debt securities including fixed-income securities* increased by €10.7 billion compared to 31 December 2019, from €33.6 billion to €44.3 billion.

Unrealised gains or losses resulting from the valuation of the security portfolio are reflected in the *Fair value reserve* within the ESM's equity position. As of 31 December 2020, this reserve amounted to €913.4 million, compared to €442.4 million as of 31 December 2019. The increase reflects the higher market value of securities investments compared to the previous year.

Profit and loss account

The ESM recorded a net income of €392.9 million for the financial year 2020, compared to €289.7 million in 2019. It is mainly composed of the amounts received from Germany, France, and Italy to compensate the ESM for the negative interest paid on the cash held in 2019 at their national central banks. These compensations, totalling €235.7 million, were recorded as *Extraordinary income* as at 31 December 2020.

The *Profit before extraordinary items*, which corresponds to the net income generated by ESM operations, increased by €105.6 million, to €157.3 million in 2020 from €51.7 million in 2019. The increase was driven by the *Net profit on financial operations*, which increased by €144.5 million to €208.3 million in 2020 from €63.8 million in 2019.

Operating costs, including depreciation of fixed assets, were €77.8 million compared to €73.2 million in 2019. The increase is mainly due to additional staff costs. The ESM provides administrative services to the EFSF and charged service fees of €33.1 million in 2020 (€33.1 million in 2019), which is recognised under *Other operating income*. The ESM continues to focus on budgetary discipline and effective cost control.

Outlook for 2021

The ESM has diversified its investments and continues to examine additional measures to mitigate the impact of the negative yield environment on the return of the paid-in capital, in line with its guidelines and its mandate. Nevertheless, the persistence of this environment is likely to affect the ESM's net income in 2021.

During the course of 2020, the Covid-19 pandemic created severe disruptions in the global economy. As the situation continues to evolve, the level of uncertainty remains high. In 2020, the ESM developed a new financial support instrument in the form of an ESM credit line (Pandemic Crisis Support) for Members' to finance health care and related costs. The possible use of that instrument by euro area member states remains uncertain and depends on future developments. Thus, its impact on ESM's net income in 2021 cannot be reliably assessed.

Balance sheet

As at 31 December 2020 (In €'000)

	Notes	31.12.2020	31.12.2019
ASSETS			
Cash in hand, balances with central banks and post office banks	4	58,217,164	64,973,149
Loans and advances to credit institutions			
(a) other loans and advances	5	11,084,040	6,412,889
		11,084,040	6,412,889
Loans and advances to euro area member states	6	89,894,688	89,894,688
Debt securities including fixed-income securities	7		
(a) issued by public bodies		22,292,608	14,637,717
(b) issued by other borrowers		21,959,682	18,932,878
		44,252,290	33,570,595
Intangible assets	8	7	18
Tangible assets	9	5,451	6,474
Subscribed capital unpaid	2.15/15	624,250,300	624,250,300
Prepayments and accrued income	10	898,944	863,108
Total assets		828,602,884	819,971,221
LIABILITIES			
Amounts owed to credit institutions	11	983,059	330,950
Debts evidenced by certificates	12		
(a) debt securities in issue		117,511,345	110,413,094
		117,511,345	110,413,094
Other liabilities	13	11,565	10,824
Accruals and deferred income	14	1,353,476	1,336,786
Total liabilities		119,859,445	112,091,654
SHAREHOLDERS' EQUITY			
Subscribed capital	2.15/15	704,798,700	704,798,700
Fair value reserve	7	913,359	442,403
Reserve fund	2.7.1/16	2,638,464	2,348,801
Profit for the financial year		392,916	289,663
Total shareholders' equity		708,743,439	707,879,567
Total equity and liabilities		828,602,884	819,971,221

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

Off-balance sheet

As at 31 December 2020 (In €'000)

	Notes	31.12.2020	31.12.2019
OFF-BALANCE SHEET			
Other items	3.6		
(a) notional value of interest rate swaps			
- interest rate swaps		67,755,500	65,201,500
(b) notional value of cross-currency assets swaps			
- receivable		15,682,419	14,512,182
- payable		(15,916,704)	(14,700,791)
(c) notional value of futures contracts			
- bond futures		-	12,500

Profit and loss account

For the financial year ending 31 December 2020 (In €'000)

	Notes	2020	2019
Interest receivable and similar income			
(a) on loans and advances to credit institutions		12,222	1,800
(b) on loans and advances to euro area member states	17	1,127,151	1,178,881
(c) on debt securities including fixed-income securities	18	139,844	124,846
(d) on debts issued		162,147	116,474
(e) other	25	460,526	423,461
		1,901,890	**1,845,462**
Interest payable and similar charges			
(a) on cash and cash equivalents	19	(309,191)	(285,828)
(b) on loans to credit institutions		(52,008)	(21,522)
(c) on debts issued		(804,892)	(830,357)
(d) on debt securities including fixed-income securities	18	(18,339)	(10,402)
(e) other	25	(725,766)	(671,059)
		(1,910,196)	**(1,819,168)**
Commissions payable		**(36)**	**(17)**
Other operating income	20	**35,089**	**34,833**
Net profit on financial operations	21	**208,292**	**63,848**
General administrative expenses			
(a) staff costs	22	(36,848)	(32,967)
- wages and salaries		(26,721)	(24,012)
- social security		(10,127)	(8,955)
of which relating to pension		*(8,924)*	*(7,751)*
(b) other administrative expenses	23	(39,214)	(38,651)
		(76,062)	**(71,618)**
Value adjustments in respect of intangible and tangible assets	8/9	**(1,712)**	**(1,624)**
Profit before extraordinary items		157,265	51,716
Extraordinary income	24	235,651	237,947
Profit for the financial year		392,916	289,663

Statement of changes in equity

For the financial year ending 31 December 2020 (In €'000)

	Subscribed capital	Fair value reserve	Reserve fund	Profit brought forward	Profit for the financial year	Total
At 1 January 2019	**704,798,700**	**140,174**	**2,064,053**	**-**	**284,748**	**707,287,675**
Allocation of the profit of 2018	-	-	-	284,748	(284,748)	-
Allocation of profit brought forward to the reserve fund	-	-	284,748	(284,748)	-	-
Profit for the financial year	-	-	-	-	289,663	**289,663**
Change in fair value reserve	-	302,229	-	-	-	**302,229**
At 31 December 2019	**704,798,700**	**442,403**	**2,348,801**	**-**	**289,663**	**707,879,567**

	Subscribed capital	Fair value reserve	Reserve fund	Profit brought forward	Profit for the financial year	Total
At 1 January 2020	**704,798,700**	**442,403**	**2,348,801**	**-**	**289,663**	**707,879,567**
Allocation of the profit of 2019	-	-	-	289,663	(289,663)	-
Allocation of profit brought forward to the reserve fund	-	-	289,663	(289,663)	-	-
Profit for the financial year	-	-	-	-	392,916	**392,916**
Change in fair value reserve	-	470,956	-	-	-	**470,956**
At 31 December 2020	**704,798,700**	**913,359**	**2,638,464**	**-**	**392,916**	**708,743,439**

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

Statement of cash flows

For the financial year ending 31 December 2020 (In €'000)

	2020	2019
Cash flows from operating activities:		
Profit for the financial year	392,916	289,663
Adjustments for value adjustments in respect of tangible and intangible assets	1,712	1,624
Changes in tangible and intangible assets	(678)	(873)
Changes in other liabilities	741	1,321
Changes in accrued interest and interest received	(1,311,973)	(1,303,465)
Changes in prepayments	(40,767)	(97,199)
Changes in accruals and deferred income and interest paid	843,169	1,017,841
Interest received	1,316,904	1,315,485
Interest paid	(826,479)	(828,678)
Net cash flow provided by operating activities	**375,545**	**395,719**
Cash flows from investing activities		
Changes in debt securities including fixed-income securities	(10,210,739)	(7,685,436)
Changes in loans and advances to credit institutions	(4,671,151)	(5,121,174)
Changes in amounts owed to credit institutions	652,109	53,748
Net cash flow used in investing activities	**(14,229,781)**	**(12,752,862)**
Cash flows from financing activities		
Payment of capital	-	65,440
Changes in debt securities in issue	7,098,251	12,019,135
Net cash flow provided by financing activities	**7,098,251**	**12,084,575**
Net decrease in cash and cash equivalents	(6,755,985)	(272,568)
Cash and cash equivalents at the beginning of the financial year	64,973,149	65,245,717
Cash and cash equivalents at the end of the financial year	**58,217,164**	**64,973,149**

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

Notes to the financial statements

1. General Information

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

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

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

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

The present financial statements cover the period from 1 January 2020 to 31 December 2020, while comparative figures cover the period from 1 January 2019 to 31 December 2019.

Following a proposal from the Managing Director, the Board of Directors adopted the financial statements on 30 March 2021 and authorised their submission to the Board of Governors for approval at its 17 June 2021 meeting.

1.1. GENERAL OVERVIEW OF THE FINANCIAL ASSISTANCE PROGRAMMES

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

- grant financial assistance in the form of loans to an ESM Member in the framework of a macroeconomic adjustment programme;
- purchase bonds or other debt securities in the primary debt market and conduct operations on the secondary debt market in relation to the bonds of an ESM Member;
- grant precautionary financial assistance to ESM Members in the form of credit lines;
- provide financial assistance for the recapitalisation of financial institutions through loans to ESM Members' governments;
- recapitalise systemic and viable euro area financial institutions directly under specific circumstances and as a last resort measure, following the 8 December 2014 ratification of the Direct Recapitalisation of Institutions instrument.

1.2. OVERVIEW OF THE PRICING STRUCTURE OF THE FINANCIAL ASSISTANCE PROGRAMMES

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

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

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

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

  - up-front service fee (50 basis points (bps)) generally deducted from the drawn amount;

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

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

  - 10 bps for loans and primary market support facilities;

  - 5 bps for secondary market support facilities;

  - 35 bps for precautionary financial assistance;

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

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

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

1.3. ESM FINANCIAL ASSISTANCE TO SPAIN

The Eurogroup, composed of the Finance Ministers of the euro area member states, reached political agreement on 20 July 2012 that financial assistance should be granted to Spain for the recapitalisation of its banking sector, following an official request from the Spanish government. The financial assistance was designed to cover the estimated capital requirements along with an additional safety margin, amounting to €100.0 billion. The loans were provided to Spain's bank recapitalisation fund, Fondo de Reestructuración Ordenada Bancaria (FROB), and then channelled to the relevant financial institutions. The assistance was initially committed under a European Financial Stability Facility (EFSF) programme. On 28 November 2012, the ESM Board of Governors decided that the ESM would assume this commitment, in line with Article 40(1) and (2) of the ESM Treaty.

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

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

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

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

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

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

On 11 November 2016, the ESM received the fourth early repayment from Spain of €1.0 billion, which was approved by the ESM Board of Directors on 7 November 2016.

The ESM received two further early repayment requests from the Spanish authorities in 2017. On 14 June 2017, the ESM received the fifth early repayment from Spain of €1.0 billion, which was approved by the ESM Board of Directors on 1 June 2017. Subsequently, on 5 October 2017, the ESM received the request for the sixth early repayment from Spain of €2.0 billion, which was approved by the ESM Board of Directors on 26 October 2017 and the repayment took place on 16 November 2017.

On 30 January 2018 Spain made the request for two further early repayments. On 23 February 2018 and 23 May 2018, the ESM received respectively the seventh and eighth early repayments from Spain of €2.0 billion and €3.0 billion, which had been approved by the ESM Board of Directors on 8 February 2018. On 16 October 2018, the ESM received the ninth early repayment from Spain of €3.0 billion, which had been approved by the ESM Board of Directors on 20 September 2018.

By 31 December 2020 and 2019, Spain had, in total, repaid €17.6 billion of its financial assistance. All repayments were made in cash.

The outstanding nominal amount of loans granted to Spain as at 31 December 2020 and 2019 is €23.7 billion (refer to note 6).

1.4. ESM FINANCIAL ASSISTANCE TO CYPRUS

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

The agreement on the macroeconomic adjustment programme led euro area member states to decide on a financial assistance package of up to €10.0 billion. On 24 April 2013, the ESM Board of Governors decided to grant stability support to Cyprus. The ESM Board of Directors subsequently approved the Financial Assistance Facility Agreement (FFA) on 8 May 2013. The ESM disbursed €6.3 billion, and the International Monetary Fund (IMF) contributed around €1.0 billion. Cyprus exited successfully from its ESM programme on 31 March 2016.

According to the terms of the FFA, the first tranche of financial assistance was provided to Cyprus in two separate disbursements: the ESM disbursed the first €2.0 billion on 13 May 2013, and transferred the second in the amount of €1.0 billion on 26 June 2013. The second tranche of assistance, €1.5 billion of ESM floating rate notes, was disbursed on 27 September 2013. The Cypriot government used the notes for the recapitalisation of the cooperative banking sector. The third tranche of assistance, €0.1 billion, was disbursed on 19 December 2013. Disbursements of a total of €1.1 billion were made in 2014, and another €0.6 billion in 2015.

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

The outstanding nominal amount of loans granted to Cyprus as at 31 December 2020 and 2019 is €6.3 billion (refer to note 6).

1.5. ESM FINANCIAL ASSISTANCE TO GREECE

The EFSF financial assistance programme for Greece expired on 30 June 2015. On 8 July 2015, the Greek government submitted a request for financial assistance to the Chairperson of the ESM Board of Governors. On 13 July 2015, the Finance Ministers of the euro area agreed with Greece a set of urgent prior actions in order to start negotiations for a new programme under the ESM. The ESM Board of Governors approved a new programme on 19 August 2015. At the same time, the ESM Boards of Governors and Directors approved the FFA with Greece, authorising the ESM to provide Greece with up to €86.0 billion in financial assistance over three years. Greece successfully exited its programme in August 2018.

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

On 20 August 2015, the ESM approved the first tranche of €26.0 billion in financial assistance for Greece, divided in two sub-tranches. This decision followed the ESM Board of Directors' approval of the FFA, specifying the terms of the financial assistance. The Board of Directors also decided to immediately disburse €13.0 billion in cash to Greece. This was the first disbursement under the first sub-tranche, of €16.0 billion, to be used for budget financing and debt servicing needs. The second sub-tranche, of €10.0 billion, was immediately created in ESM floating rate notes and held in a segregated account. These funds were designated to cover the Greek banking sector's potential resolution and recapitalisation costs, with release decisions to be taken on a case-by-case basis.

On 23 November 2015, the Board of Directors authorised the disbursement of €2.0 billion in cash to Greece as the second disbursement under the €16.0 billion sub-tranche approved in August 2015. This decision followed the Greek government's completion of the first set of reform milestones. This disbursement was primarily used for debt servicing.

On 1 December 2015, the Board of Directors decided to release €2.7 billion to Greece to recapitalise Piraeus Bank. Subsequently, on 8 December 2015, the Board of Directors decided to release €2.7 billion to Greece to recapitalise the National Bank of Greece. The ESM transferred these amounts under the €10.0 billion sub-tranche, held in ESM notes in a segregated account. The availability period of the remaining €4.6 billion expired on 31 January 2016.

On 22 December 2015, the Board of Directors approved the disbursement of €1.0 billion to Greece as the third and final disbursement under the €16.0 billion sub-tranche agreed in August 2015. This decision followed the Greek government's completion of the second set of reform milestones. This disbursement was also used for debt servicing.

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

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

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

On 20 February 2017, the ESM received a loan repayment of €2.0 billion from the Greek government. The repayment was a contractual obligation with the ESM and followed the sale of an asset by one of the banks that took part in the 2015 banking recapitalisation, financed with ESM loans.

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

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

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

On 14 June 2018, the ESM Board of Directors authorised the release of the remaining amount of the fourth tranche of ESM financial assistance, approved on 27 March 2018. The disbursement of €1.0 billion was used for the clearance of arrears.

On 6 August 2018, the ESM disbursed the fifth and final tranche of ESM financial assistance for Greece, amounting to €15.0 billion. Out of this tranche, €9.5 billion was used for building up Greece's cash buffer and €5.5 billion was used for debt service. After the disbursement, the cash buffer reached around €24.0 billion. That sum was to cover around 22 months of Greece's financing needs after the end of the programme on 20 August 2018.

On 20 August 2018, Greece officially concluded its three-year ESM financial assistance programme with a successful exit. This followed the disbursement of a total of €61.9 billion by the ESM over three years in support of macroeconomic adjustment and bank recapitalisation in Greece. The remaining €24.1 billion available under the maximum €86.0 billion programme volume was not utilised and was automatically cancelled.

The outstanding nominal amount of loans granted to Greece as at 31 December 2020 and 2019 is €59.9 billion (refer to note 6).

1.6. ESM COVID-19 PANDEMIC CRISIS SUPPORT

On 9 April 2020, the Eurogroup decided on a comprehensive economic policy response to the Covid-19 crisis. Three important safety nets for workers, businesses and sovereigns were established, amounting to a package worth €540 billion. The ESM is the safety net for sovereigns and for this purpose created a Pandemic Crisis Support instrument. It is a credit line to support domestic financing of healthcare related costs due to the Covid-19 crisis, which can be requested by all ESM Members. On 23 April 2020, the EU Heads of State or Government (European Council) endorsed this agreement. On 8 May 2020, the Eurogroup agreed on the features of the credit line. It was made operational by the ESM Board of Governors on 15 May 2020. No Member State has requested this credit line as at 31 December 2020.

2. Summary of significant accounting policies

The principal accounting policies applied in the preparation of these financial statements are set out below.

2.1. BASIS OF PRESENTATION

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

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

The preparation of financial statements in conformity with the Directives requires the use of certain critical accounting estimates. It also requires management[7] to exercise its judgement in applying the ESM's accounting policies. Areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the financial statements are disclosed in Note 2.3.

2.2. BASIS OF MEASUREMENT

The accompanying financial statements are prepared on a historical cost basis, except the debts evidenced by certificates which are measured at amortised cost, and the paid-in capital and reserve fund investments which are measured at fair value with gains and losses recognised in the fair value reserve. The bond and interest rate futures are measured at fair value with the changes in the values (mark-to-market) recognised in the profit and loss account.

2.3. USE OF ESTIMATES

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

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

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

No value adjustment was required as at 31 December 2020 and 2019, thus none has been recorded.

2.4. FOREIGN CURRENCY TRANSLATION

The ESM uses the euro (€) as the unit of measure of its accounts and for presenting its financial statements.

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

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

---

[7] As per Article 7 (5) of the ESM Treaty, the Managing Director shall conduct, under the direction of the Board of Directors, the current business of the ESM. As per Article 21 (1) of the ESM By-Laws, the Board of Directors shall keep the accounts of the ESM and draw up its annual accounts.

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

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

2.5. DERIVATIVE FINANCIAL INSTRUMENTS

The ESM uses derivatives instruments for risk management purposes. Cross-currency asset swaps and foreign exchange swaps are used to hedge the currency risk into euro[8] (refer to Note 3.3.2), and interest rate swaps to manage the interest rate risk exposure (refer to Note 3.3.1).

All cross-currency asset swaps, foreign exchange swaps and interest rate swaps transactions are booked at notional amount as off-balance sheet items at the date of the transaction.

The ESM uses also futures contracts in order to manage the interest rate risk of the paid-in capital portfolios (refer to Note 3.3.1). The futures transactions are booked at notional amount as off-balance sheet items at the date of the transaction.

2.5.1. FOREIGN EXCHANGE SWAPS AND FORWARDS

For the management of its paid-in capital portfolios as well as issuances in USD, the ESM can enter into foreign exchange swaps and forwards to hedge back into euro non-euro denominated investments. Ongoing forward and spot exchange transactions are converted at the spot rates of exchange prevailing on the balance sheet date and neutralised in 'Accruals and deferred income' or 'Prepayments and accrued income'. The spread between the spot amount and forward settlement amount is linearly amortised through the profit and loss account in 'Interest receivable and similar income' or 'Interest payable and similar charges'. On the maturity date, the parties exchange the initial principal amounts at the contractual exchange rate. The difference between the spot and the forward rate at maturity is recognised under the caption 'Interest receivable and similar income' or 'Interest payable and similar charges' in the profit and loss account.

2.5.2. CROSS-CURRENCY ASSET SWAPS AND INTEREST RATE SWAPS

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

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

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

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

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

All interest rate swaps and cross-currency asset swaps contracted with commercial counterparties are concluded under the contractual framework of ISDA swap agreements and Credit Support Annexes (CSA), which specify the conditions of exposure collateralisation, in order to offset mark-to-market fluctuations on a daily basis through the exchange of collateral. These are generally accepted and practised contract types (see also Note 3.6.3). Derivative operations concluded with selected highly rated public institutions or central banks can be concluded under ISDA swap agreement only.

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

2.5.3. FUTURES CONTRACTS

Futures contracts are financial instruments, which provide the ability to buy or sell an underlying item at a forward date, at a pre-agreed price. Futures contracts are standardised exchange-traded derivative instruments with pre-defined maturity, underlying items and specifications. ESM enters into bond futures and interest rate futures.

At the delivery date of the contract, if positions have not been closed or rolled to the next contract, short bond futures positions must deliver a bond from a pre-set basket of possible deliverable bonds, with a pre-defined remaining maturity, to the long positions. Short interest rate futures position must deliver the interest earned on a notional amount of the contracts, to the long position.

The ESM enters in futures contracts with the objective to manage the interest rate risk of the paid-in capital portfolios. The futures are initially recognised at zero including any transaction costs, and measured subsequently at fair value with gains and losses recognised in the profit and loss account under the caption 'Interest receivable and similar income – Other' or ' Interest payable and similar charges – Other'.

The changes in the values (mark-to-market) of futures positions are recognised in the profit and loss account through the daily margin calls. Therefore, the carrying amounts of futures represent only the called but not yet settled balances and are recognised under the caption 'Other assets' or 'Other liabilities'.

2.6. CASH IN HAND, BALANCES WITH CENTRAL BANKS AND POST OFFICE BANKS

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

2.7. DEBT SECURITIES INCLUDING FIXED-INCOME SECURITIES

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

2.7.1. PAID-IN CAPITAL AND RESERVE FUND INVESTMENTS

The ESM's capital provisions are laid down in Chapter 3 of the ESM Treaty. The initial aggregate nominal value of paid-in shares was €80.0 billion and has been increased to €80.5 billion due to the accession of Latvia and Lithuania. The net income generated by ESM operations and the proceeds of the financial sanctions received from the ESM Members under the multilateral surveillance procedure, the excessive deficit procedure, and the macro-economic imbalances procedure established under the Treaty on the Functioning of the European Union (TFEU) are put aside in a reserve fund, in accordance with Chapter 5 of the ESM Treaty.

The paid-in capital and the reserve fund (the Investment Portfolios) are invested in accordance with the ESM Investment Guidelines 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.

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

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

In accordance with the Investment Guidelines, the Investment Portfolios are divided in the Short-term tranche, the Medium- and long-term tranche and the Hold-to-maturity tranche. The assets of the reserve fund are invested in full in the Short-term tranche:

Short-term tranche

The tranche with the highest liquidity requirements is the Short-term tranche. The main objective of the Short-term tranche is to enable the ESM to face any temporary disbursement to cover any liquidity shortfall, due to a non-payment by a beneficiary member state. This tranche is invested in liquid investment instruments with a capital preservation objective at a one-year horizon, for a high level of confidence, to the extent possible in light of prevailing market conditions.

Medium- and long-term tranche

The main objective of the Medium- and Long-term tranche is to ensure the ESM's financial strength. This tranche is managed to enhance the return of the Investment Portfolios, subject to the investment objectives and constraints specified in the Investment Guidelines. This tranche is also mainly invested in liquid instruments.

Hold-to-maturity tranche

The objective of the Hold-to-maturity tranche is to reinforce the long-term financial strength of the ESM. This tranche shall be invested to enhance the return of the Investment Portfolios, subject to the other investment objectives specified in the Investment Guidelines, as well as to comply, as of the time of purchase, with the eligibility criteria set out in the General Eligible Assets List.

The assets in the Hold-to-maturity tranche are intended to be held to maturity, and may be monetised only:

i. in order to raise liquidity if, in accordance with the ESM High Level Risk Policy, it is necessary to meet due payments to ESM creditors and to avoid or limit a capital call under Article 9(3) of the ESM Treaty; or

ii. outside of the situation referred in "i". above, to post collateral for derivatives used for risk management purposes in the Investment Portfolios;

iii. in case any asset loses its eligibility, the ESM may decide to reduce the exposure to this given asset, but to do so within an appropriate timeframe and manner in order to minimise any impact on market prices.

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

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

The paid-in capital investments in the Hold-to-maturity tranche are initially recognised at cost and measured subsequently at amortised cost.

2.7.2. LIQUIDITY BUFFER INVESTMENTS

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

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

2.7.3. DETERMINATION OF FAIR VALUE

The determination of fair values of financial assets and liabilities is based on quoted market prices or dealer price quotations, when such prices are regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis.

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

2.8. LOANS AND ADVANCES TO CREDIT INSTITUTIONS AND TO EURO AREA MEMBER STATES

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

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

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

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

2.9. INTANGIBLE ASSETS

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

2.10. TANGIBLE ASSETS

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

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

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

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

2.11. PREPAYMENTS AND ACCRUED INCOME

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

2.12. AMOUNTS OWED TO CREDIT INSTITUTIONS

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

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

2.13. DEBTS EVIDENCED BY CERTIFICATES

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

2.14. PROVISIONS

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

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

2.15. SUBSCRIBED CAPITAL

On 31 December 2020 and 2019, the ESM's shareholders were the 19 euro area member states. In accordance with Article 8 of the ESM Treaty, the authorised capital is €704.8 billion, which is divided into 7,047,987 shares, with a nominal value of €100,000 each. The authorised capital was subscribed by the shareholders according to the contribution key provided in Article 11 and calculated in Annex I of the ESM Treaty. The authorised capital is divided into paid-in shares and callable shares, where the total aggregate nominal value of paid-in shares is €80.5 billion.

In accordance with Article 4 of Directive 86/635/EEC as amended, the authorised capital stock is recognised in equity as subscribed capital. The callable shares are presented as 'Subscribed capital unpaid' on the asset side of the balance sheet. Called capital not yet paid by the shareholders is recognised on the asset side of the balance sheet as 'Subscribed capital called but not paid'.

2.16. ACCRUALS AND DEFERRED INCOME

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

2.17. INTEREST RECEIVABLE AND PAYABLE

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

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

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

2.18. EMPLOYEE BENEFITS

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

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

2.19. COMPENSATION PAYMENTS FROM ESM MEMBERS

Payments received from a Member State as compensation for expenses or losses (refer to Note 24) incurred in a previous period are recorded as extraordinary income in profit or loss of the period in which they become receivable. Such compensation payments are made with a view to preserve the ESM's capital and are granted on a case-by-case basis, subject to conditions not controlled by the ESM. Therefore, a receivable is evidenced either through a notification of the payment or the respective transfer of money.

2.20. TAXATION

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

3. Risk management

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

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

3.1. RISK MANAGEMENT ORGANISATION

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

According to the ESM's High Level Risk Policy (published on ESM website) and Annex, the targeted risk appetite should preserve the ESM's funding capacity, ensure the highest creditworthiness, and avoid unexpected capital calls. The High Level Risk Policy and Annex describe the risk appetite and the framework for identifying, assessing, monitoring and managing risks consistent with the risk appetite. It covers all ESM financial and non-financial risks, and both on- and, if applicable, off-balance sheet items. The risk profile is defined by a set of limits to curtail all types of risks within the risk appetite. The ESM does not aim at generating profit on financial support granted to beneficiary Member States and aims to manage its investment portfolios prudently, in accordance with the ESM Investment Guidelines and ESM's risk policies.

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

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

The Chief Risk Officer (who is also the ESM's Deputy Managing Director) reports directly to the Managing Director. The Chief Risk Officer is responsible and accountable for informing the Managing Director on all risks which the institution may face to ensure enforcement and oversight. The Managing Director reports risk-related information to the Board of Directors, principally through the Board Risk Committee.

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

Covid-19 Pandemic impact and risk management response

The pandemic has seriously affected the economic performance and forecast of all European countries, including the ESM beneficiary member states (BMS). The significant drop in the GDP of all countries and the global recession couples with high uncertainty over the short and medium term developments. However, a robust national and supranational policy response has helped to contain the consequences. In particular, the combination of these measures with the extremely low interest rates and the strong commitment from EU institutions have led to a significant response from investors. As a result, all BMS maintain stable market access at favourable terms that, together with sizable cash buffers for some more vulnerable countries, mitigate any liquidity risk over the short term. Moreover, the positive impact of the European funds on the countries' growth path together with the expected low-for-long funding costs mitigate long-term sustainability risks, which is also relevant for the main ESM exposures.

During 2020, the ESM risk assessment and impairment assessment methodology duly captured (via its Early Warning System) the severe impact from the pandemic, together with the related risks and the recent developments. In particular, the assessment focused on whether the effects of the pandemic triggered a significant increase in credit risk and if it would materialise in an expected credit loss (ECL). In that context, a complete assessment of a wide range of inputs based on forward-looking information was performed, to ensure a comprehensive assessment of all short-term and medium-to-long term factors and consequences. As described above, inputs include short-term economic data, vulnerability indicators, liquidity balances and market indicators, together with medium-to-long term risks, policy measures and mitigating factors.

All those factors, and in particular the strong liquidity position and market access of BMS, are expected to adequately balance the economic shock caused by the pandemic and address the related risks. The liquidity risk can be a major concern in a crisis context, therefore the positive funding performance of BMS, including the most vulnerable ones, represent a remarkable balancing element. Because of this and all elements included, as of 31 December 2020 the assessment did not identify a significant increase in credit risk on the ESM's exposures to BMS. The overall credit quality of the ESM loans portfolio remained relatively stable.

Risk management also performed credit risk scenarios of ESM investment/funding counterparties whose ratings are more vulnerable to downward rating pressures due to the Covid-19 pandemic. The analysis aimed to show the results of medium-term scenarios of how the credit rating of the ESM investment portfolio counterparties could change in the future. The scenarios were useful to see where the current ESM investment portfolio was particularly vulnerable from the perspective of potential credit rating downgrades. The analysis did not identify a significant increase in credit risk generated by the impact of the Covid-19 pandemic on the ESM investment portfolio.

Brexit and risk management response

The UK formally exited the EU on 29 March 2019, and then a transition period was agreed until 31 December 2020 to negotiate a withdrawal agreement on the principles of the future relationship between the EU and the UK. After intensive negotiations, the European Commission reached on 24 December 2020 an agreement with the United Kingdom on the terms of its future cooperation with the European Union: the EU-UK Trade and Cooperation Agreement.

ESM Risk Management had already carried out an institution-wide risk assessment on Brexit in 2018. This assessment was shared with the Internal Risk Committee, which consequently decided to no longer invest in UK-based issuers. As at 31 December 2020, the ESM does not have any investment exposure to UK-based assets but only some GBP denominated investments (hedged back to EUR) from one International Financial Institution and one non-EU issuer.

In terms of derivative exposure, the ESM materially reduced its derivative exposures to UK-based banks in 2019 and 2020. There is comparatively little exposure remaining, which is collateralised on a daily basis as mark-to-market valuations change.

3.2. CREDIT RISK

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

Given the nature of the ESM's mandate, where credit risk from lending arises as a result of support to beneficiary member states under a financial assistance facility agreement (FFA), the credit risk in the ESM's lending exposure is accepted. The ESM has established an early warning procedure to ensure that it receives any repayments due by a beneficiary member state under a FFA in a timely manner. The note 3.2.4 below further describes the ESM's treatment of loans to euro area member states.

3.2.1. EXPOSURE TO CREDIT RISK WITHOUT TAKING INTO ACCOUNT ANY COLLATERAL OR OTHER CREDIT ENHANCEMENTS

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

(in €'000)	Exposure 31.12.2020	Exposure 31.12.2019
Cash in hand, balances with central banks and post office banks	58,217,164	64,973,149
Loans and advances to credit institutions	11,084,040	6,412,889
Debt securities including fixed-income securities	44,252,290	33,570,595
On balance sheet credit risk exposure	**113,553,494**	**104,956,633**
Exposure at default on derivatives (1)	1,309,518	1,889,469
Credit risk exposure	**114,863,012**	**106,846,102**

(1) The cash-collateral is included in the calculation of the Exposure at Default and reported as exposure in the on balance sheet items.

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

3.2.2. RISK PROFILE OF COUNTERPARTIES AND ISSUERS

The following tables show the breakdown of the financial assets by credit rating. For 'Debt securities including fixed-income securities', the credit ratings of individual issuances (or in the case of short-term securities, their long-term rating equivalents) are presented. If issuance ratings are unavailable, the issuer's rating is presented. For other financial assets, the credit ratings of the counterparties are presented.

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

(in €'000)	Credit rating (1)	Clean carrying value 31.12.2020
Cash in hand, balances with central banks and post office banks	not rated (2)	58,215,304
	AA	1,860
Loans and advances to credit institutions	not rated (3)	980,547
	AA	808,773
	AA-	2,461,920
	A+	4,449,170
	A-	2,383,630
Debt securities including fixed-income securities	AAA	24,862,836
	AA+	3,173,727
	AA	8,382,359
	AA-	1,488,911
	A+	1,205,264
	A	5,139,193
Total		**113,553,494**

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

(in €'000)	Credit rating (1)	Clean carrying value 31.12.2019
Cash in hand, balances with central banks and post office banks	not rated (2)	64,967,836
	AA	5,313
Loans and advances to credit institutions	not rated (3)	330,216
	AA	1,603
	AA-	780
	A+	3,906,450
	A	2,173,840
Debt securities including fixed-income securities	AAA	19,872,817
	AA+	1,330,075
	AA	4,056,564
	AA-	2,852,980
	A+	666,802
	A	4,791,357
Total		**104,956,633**

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

3.2.3. CREDIT RISK ON DEBT SECURITIES INCLUDING FIXED-INCOME SECURITIES

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

3.2.4. CREDIT RISK IN RELATION TO LOANS TO EURO AREA MEMBER STATES

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

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

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

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

3.3. MARKET RISK

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

3.3.1. INTEREST RATE RISK

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

Interest rate risk on Lending and Funding is the risk of a mismatch between the interest rate re-pricing of loans granted to beneficiary member states and of its funding raised through bills and bond issuances. The exposure to interest rate risk arises from differences in repricing and maturity characteristics of the different asset, liability, and hedging instruments.

All funding costs are passed through to beneficiary member states under financial assistance, as defined by the ESM Pricing Policy.

Interest rate risk on investments is the risk of market loss due to an adverse change in the overall level of interest rates affecting the value of the investment portfolios' holdings. This risk is monitored and controlled on a daily basis through risk indicators and stress tests. Duration bands, cumulated and partial sensitivities, one day Value at Risk (VaR) with a 99% level of confidence are part of the daily measures that frame the interest rate risk potential exposure. To complement these measures, a series of stress tests with flattening, steepening and parallel shifts of all or a selected number of interest rate curves is daily processed as part of the risk report.

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

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

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

- For the Short-term tranche, the capital shall be preserved at a one-year horizon, for a high level of confidence, to the extent possible in light of prevailing market conditions.

- For the Medium and Long-term tranche, the capital shall be preserved at a three-year horizon for a high level of confidence, to the extent possible in light of prevailing market conditions.

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

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

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

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

The preservation of the maximum lending capacity of the ESM requires the investment portfolios' market value to remain above €75.0 billion, with the Short-term, Medium and Long-term and Hold-to-maturity tranches valued in mark-to-market. However, the Hold-to-maturity tranche is considered as being interest rate insensitive in the other risk measures as it is valued at amortised cost.

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

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

3.3.2. CURRENCY RISK

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

The ESM is exposed to currency risk whenever there is a currency mismatch between its assets and liabilities. Potential sources of currency risk are paid-in capital investments in non-euro denominated assets and funding activities in foreign currencies.

In 2020 and 2019, the ESM undertook investment activities in foreign currency assets, mainly Japanese yen and US dollars. In compliance with the Article 2 (5) of the ESM Investment Guidelines, currency risk is hedged into euro to ensure a limited remaining foreign exchange risk for the ESM (refer to Note 3.6).

The ESM also conducts funding activities in US dollars. In 2017, the ESM decided to broaden its investor base and spread its funding liquidity risk across the euro and dollar markets. On 31 October 2017, the ESM priced its inaugural US dollar issue, raising $3.0 billion. On 23 October 2018, the ESM raised $3.0 billion by issuing a new 2-year bond, its second deal in the dollar market, followed by a 5-year $2.0 billion bond issuance on the 11 September 2019. On 10 September 2020, ESM raised $3.0 billion and the ESM has hedged the proceeds back into euros (refer to Note 3.6.1.2).

As it is the case for derivatives used to manage interest rate risk, operations contracted with commercial banks are fully collateralised, thanks to the exchange of cash and highly rated securities, regulated by collateral agreements (ISDA and Credit Support Annex).

31 December 2020 (in €'000)	Euro (EUR)	Japanese Yen (JPY)	US Dollar (USD)	Swedish Krone (SEK)	Other currencies	Total
ASSETS						
Cash in hand, balances with central banks and post office banks	58,217,164	-	-	-	-	**58,217,164**
Loans and advances to credit institutions	11,084,040	-	-	-	-	**11,084,040**
Loans and advances to euro area member states	89,894,688	-	-	-	-	**89,894,688**
Debt securities including fixed-income securities	34,952,927	4,895,465	3,488,002	287,095	628,801	**44,252,290**
Prepayments and accrued income	858,363	3,376	36,155	1,050	-	**898,944**
Total financial assets	**195,007,182**	**4,898,841**	**3,524,157**	**288,145**	**628,801**	**204,347,126**
LIABILITIES						
Amounts owed to credit institutions	983,059	-	-	-	-	**983,059**
Debt securities in issue	111,013,922	-	6,497,423	-	-	**117,511,345**
Other liabilities	11,565	-	-	-	-	**11,565**
Accruals and deferred income	1,207,880	74,879	68,558	2,129	-	**1,353,476**
Total financial liabilities	**113,216,426**	**74,879**	**6,566,011**	**2,129**	**-**	**119,859,445**
Shareholders' equity [(1)]	84,493,139	-	-	-	-	**84,493,139**
Total shareholders' equity	**84,493,139**	**-**	**-**	**-**	**-**	**84,493,139**
Off-balance sheet derivatives	**2,268,435**	**(4,819,614)**	**3,193,138**	**(284,026)**	**(592,217)**	**(234,284)**
Net of financial position	**(433,948)**	**4,348**	**151,284**	**1,990**	**36,584**	**(239,742)**

[(1)] Excluding subscribed capital unpaid.

31 December 2019 (in €'000)	Euro (EUR)	Japanese Yen (JPY)	US Dollar (USD)	Swedish Krone (SEK)	Other currencies	Total
ASSETS						
Cash in hand, balances with central banks and post office banks	64,973,149	-	-	-	-	64,973,149
Loans and advances to credit institutions	6,412,889	-	-	-	-	6,412,889
Loans and advances to euro area member states	89,894,688	-	-	-	-	89,894,688
Debt securities including fixed-income securities	25,637,523	4,836,720	2,442,099	180,391	473,862	33,570,595
Prepayments and accrued income	809,411	3,418	49,296	983	-	863,108
Total financial assets	187,727,660	4,840,138	2,491,395	181,374	473,862	195,714,429
LIABILITIES						
Amounts owed to credit institutions	330,950	-	-	-	-	330,950
Debt securities in issue	103,309,606	-	7,103,488	-	-	110,413,094
Other liabilities	10,824	-	-	-	-	10,824
Accruals and deferred income	1,157,079	100,400	76,571	2,736	-	1,336,786
Total financial liabilities	104,808,459	100,400	7,180,059	2,736	-	112,091,654
Shareholders' equity [1]	83,629,267	-	-	-	-	83,629,267
Total shareholders' equity	83,629,267	-	-	-	-	83,629,267
Off-balance sheet derivatives	423,942	(4,730,876)	4,729,660	(177,088)	(446,747)	(201,109)
Net of financial position	(286,124)	8,862	40,996	1,550	27,115	(207,601)

[1] Excluding subscribed capital unpaid.

3.4. LIQUIDITY RISK

The ESM will honour its obligations under its issued debt securities from proceeds that stem from its support programmes, supported by its subscribed capital. The ESM monitors its liquidity position on a daily basis by assessing its funding liquidity risk and market liquidity risk.

Funding liquidity risk is defined as the risk of loss arising from difficulty in securing the necessary funding, or from a significantly higher cost of funding than normal levels, due to a deterioration of the ESM's creditworthiness, or at a time of unfavourable market conditions (such as periods of high stress). Funding liquidity risk is managed by maintaining permanent market access to a wide investor base with different funding instruments, multiple credit lines and maintaining an adequate liquidity buffer. The market presence in the USD market, which started in 2017, reduces further the funding liquidity risk as it gives access to additional investors in a different market. At the end of December 2020, the ESM's liquidity buffer stood at €18.3 billion (2019: €15.1 billion).

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

Despite the general context of uncertainty in the global financial markets due to the Covid-19 pandemic, the ESM continued to maintain a robust liquidity position and diversified access to the necessary liquidity sources, also thanks to its prudent approach to liquidity management.

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

31 December 2020 (in €'000)	Less than 3 months	From 3 months to 1 year	From 1 to 5 years	More than 5 years	Total
ASSETS					
Cash in hand, balances with central banks and post office banks	58,217,164	-	-	-	**58,217,164**
Loans and advances to credit institutions	11,084,040	-	-	-	**11,084,040**
Loans and advances to euro area member states	-	-	2,215,000	87,679,688	**89,894,688**
Debt securities including fixed-income securities	301,335	1,456,158	20,757,537	21,737,260	**44,252,290**
Prepayments and accrued income	370,811	527,927	-	206	**898,944**
Total financial assets	**69,973,350**	**1,984,085**	**22,972,537**	**109,417,154**	**204,347,126**
LIABILITIES					
Amounts owed to credit institutions	983,059	-	-	-	**983,059**
Debt securities in issue	17,496,679	15,521,121	41,607,472	42,886,073	**117,511,345**
Other liabilities	11,565	-	-	-	**11,565**
Accruals and deferred income	340,845	418,427	92,983	501,221	**1,353,476**
Total financial liabilities	**18,832,148**	**15,939,548**	**41,700,455**	**43,387,294**	**119,859,445**
Shareholders' equity [1]	-	-	-	84,493,139	**84,493,139**
Total shareholders' equity [2]	-	-	-	**84,493,139**	**84,493,139**
Net of financial position	**51,141,202**	**(13,955,463)**	**(18,727,918)**	**(18,463,279)**	**(5,458)**

[1] Excluding subscribed capital unpaid.
[2] Shareholder equity has no defined maturity.

31 December 2019 (in €'000)	Less than 3 months	From 3 months to 1 year	From 1 to 5 years	More than 5 years	Total
ASSETS					
Cash in hand, balances with central banks and post office banks	64,973,149	-	-	-	**64,973,149**
Loans and advances to credit institutions	6,412,889	-	-	-	**6,412,889**
Loans and advances to euro area member states	-	-	-	89,894,688	**89,894,688**
Debt securities including fixed-income securities	361,112	651,017	17,426,190	15,132,276	**33,570,595**
Prepayments and accrued income	91,652	544,816	-	226,640	**863,108**
Total financial assets	**71,838,802**	**1,195,833**	**17,426,190**	**105,253,604**	**195,714,429**
LIABILITIES					
Amounts owed to credit institutions	330,950	-	-	-	**330,950**
Debt securities in issue	17,500,357	13,166,107	32,893,240	46,853,390	**110,413,094**
Other liabilities	10,824	-	-	-	**10,824**
Accruals and deferred income	358,966	424,464	130,418	422,938	**1,336,786**
Total financial liabilities	**18,201,097**	**13,590,571**	**33,023,658**	**47,276,328**	**112,091,654**
Shareholders' equity [1]	-	-	-	83,629,267	**83,629,267**
Total shareholders' equity [2]	-	-	-	**83,629,267**	**83,629,267**
Net of financial position	**53,637,705**	**(12,394,738)**	**(15,597,468)**	**(25,651,991)**	**(6,492)**

[1] Excluding subscribed capital unpaid.
[2] Shareholder equity has no defined maturity.

3.5. OPERATIONAL RISK

Operational risk is defined as the potential loss or damage, and/or the inability of the ESM to fulfil its mandate, resulting from inadequate or failed internal processes, people, and systems or from external events. The categorisation of the ESM operational risks is based on guidance from the Basel Committee on Banking Supervision, as follows:

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

Management has no tolerance for material operational risks, including those originating from third party/vendor engagements, which may result in the ESM's inability to effectively fulfil its mandate, or in significant loss and/or reputational damage. No material operational risk losses were identified in 2020 and in 2019.

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

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

The ESM has continued to operate smoothly in a full telework set-up since the beginning of the Covid-19 pandemic thanks to the Business Continuity framework. No operational risk events had a direct link to the remote working set-up.

3.6. DERIVATIVES

The ESM uses derivative instruments as described in Note 2.5 for risk management purposes and this as part of its investment and funding activities. In 2015, the ESM entered into foreign exchange derivative transactions such as foreign exchange swaps and forward contracts to hedge the currency risk related to short-term non-euro denominated investments. Since 2017, the ESM has also entered into interest rate swaps to manage globally the investment portfolio's interest rate exposure and to decrease the interest rate volatility on Greece's debt repayments. Longer-term cross currency asset swaps were contracted as well to hedge longer-term non-euro denominated investments and to hedge in euro the issuances in USD. In 2019, the ESM also started to use bond futures and in 2020 interest rate futures to manage the interest rate risk of the paid-in capital portfolio. There was no open positions as at 31 December 2020 for interest rate futures as well as bond futures.

On 31 December 2020, the derivative instruments had a maximum maturity up to 30 years (2019: maximum maturity up to 29 years) and were concluded with euro area central banks, international financial institutions and commercial banks.

3.6.1. FUNDING-RELATED DERIVATIVES

The derivatives used in the context of funding are:

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

3.6.1.1. INTEREST RATE SWAPS

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

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

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

Interest rate swaps (in €'000)	31.12.2020	31.12.2019
Notional amount	57,790,000	59,062,000
Positive fair value	1,435,610	995,527
Negative fair value	(11,823,215)	(6,865,169)

3.6.1.2. CROSS-CURRENCY ASSET SWAPS

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

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

Cross-currency assets swaps (in €'000)	31.12.2020	31.12.2019
Notional amount	6,519,436	7,121,239
Positive fair value	-	258,892
Negative fair value	(239,636)	(30,218)

3.6.1.3. FOREIGN EXCHANGE (FX) SWAPS

In a foreign exchange swap, two parties agree to exchange the principal amounts of two different currencies at the beginning of the transaction and the amounts to exchange at maturity.

Starting from 2020, the ESM entered into FX swaps with short-term maturities to hedge the cash in USD temporarily held at the BIS in order to cover the potential risk of not being able to repay the USD to the bond investors on time at maturity of the bond issuances in USD.

There were no FX swaps position as at 31 December 2020 and as at 31 December 2019.

3.6.2. INVESTMENT-RELATED DERIVATIVES

The derivatives used in the context of investment activity are:

- Interest rate swaps;
- Cross-currency asset swaps;
- Foreign exchange (FX) swaps;
- Bond and interest rate futures contracts.

3.6.2.1. INTEREST RATE SWAPS

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

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

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

Interest rate swaps (in €'000)	31.12.2020	31.12.2019
Notional amount	9,965,500	6,139,500
Positive fair value	56,486	10,426
Negative fair value	(349,018)	(210,750)

3.6.2.2. FOREIGN EXCHANGE (FX) SWAPS

In a foreign exchange swap, two parties agree to exchange the principal amounts of two different currencies at the beginning of the transaction and the amounts to exchange at maturity.

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

There were no Foreign Exchange (FX) swaps position as at 31 December 2020 and as at 31 December 2019.

3.6.2.3. CROSS-CURRENCY ASSET SWAPS

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

Starting in 2017, the ESM has invested in non-euro denominated securities with longer maturities (above 2 years), using cross-currency swaps to hedge their cash flows in euro.

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

Cross-currency asset swaps (in €'000)	31.12.2020	31.12.2019
Notional amount	9,162,983	7,390,943
Positive fair value	164,944	20,166
Negative fair value	(224,036)	(518,579)

3.6.2.4. FUTURES CONTRACTS

The ESM also uses futures contracts in order to manage portfolio interest rate risk by either buying or selling futures contracts.

The following table shows the bond futures contracts according to their notional amount. The notional amounts are disclosed off balance sheet. The fair value of futures contracts is zero at year-end, as the contracts are settled on a daily basis.

Bond futures contracts (in €'000)	31.12.2020	31.12.2019
Notional amount	-	12,500

3.6.3. CREDIT RISK ON DERIVATIVES

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

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

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

- Contractual framework

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

- Counterparty selection

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

- Collateralisation

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

- Settlement limits

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

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

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

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

(in €'000)	31.12.2020	31.12.2019
Current account balances with euro area central banks [1]	58,215,304	64,967,836
Current account balances with other banks [2]	1,860	5,313
Total cash in hand, balances with central banks and post office banks	58,217,164	64,973,149

[1] During the financial year, the ESM held balances with national central banks of France (Banque de France), Germany (Deutsche Bundesbank), Italy (Banca d'Italia) and Netherlands (De Nederlandsche Bank), as well as with the European Central Bank.
[2] The ESM holds current accounts for operational purposes with a state-owned bank as well as clearing accounts with custodians. No current account is held with post office banks.

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

5. Loans and advances to credit institutions

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

(in €'000)	31.12.2020	31.12.2019
Cash collateral provided	10,101,890	6,081,320
Reverse repos	980,547	329,966
Other deposits	1,603	1,603
Total loans and advances to credit institutions	11,084,040	6,412,889

Other deposits consist entirely of the lease guarantee deposit in relation to the ESM rental agreement. The cash collateral provided relates entirely to derivatives transactions. The reverse repurchase agreements ('reverse repos') are centrally cleared transactions on regulated markets.

6. Loans and advances to euro area member states

In accordance with Article 9 of the ESM Treaty, the Board of Governors may decide to grant financial assistance in the form of a loan to an ESM Member (refer to Note 26).

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

(in €'000)	No. of loans	Nominal amount	Clean carrying value as at 31 December 2020
Loans to euro area member states			
- to Spain	5	23,721,460	23,721,460
- to Cyprus	9	6,300,000	6,300,000
- to Greece	11	59,873,228	59,873,228
Total	25	89,894,688	89,894,688

(in €'000)	No. of loans	Nominal amount	Clean carrying value as at 31 December 2019
Loans to euro area member states			
- to Spain	5	23,721,460	23,721,460
- to Cyprus	9	6,300,000	6,300,000
- to Greece	11	59,873,228	59,873,228
Total	25	89,894,688	89,894,688

The following table shows the movements of the loans to euro area member states during 2019 and 2020:

(in €'000)	
1 January 2019 balance	89,894,688
New disbursements	-
Early repayments	-
31 December 2019 balance	89,894,688

(in €'000)	
1 January 2020 balance	89,894,688
New disbursements	-
Early repayments	-
31 December 2020 balance	89,894,688

Following the unfolding of Covid-19, the ESM has performed a qualitative assessment of the pandemic's effect on its loan book. In this context, a vulnerability assessment, including a wide range of inputs, has been performed at country level, evaluating the sensitivity of relevant exposures to the Covid-19 crisis. Such assessment returned the outcome that, as of 31 December 2020, the overall credit quality of the ESM loans portfolio remained relatively stable.

7. Debt securities including fixed-income securities

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

31 December 2020 (in €'000)	Amortised cost	Unrealised gains	Carrying amount	Nominal amount
Short-term, medium-term and long-term tranche	37,549,098	913,359	38,462,457	37,202,598
Hold-to-maturity tranche	5,789,833	-	5,789,833	5,479,267
Total debt securities including fixed income securities	43,338,931	913,359	44,252,290	42,681,865

31 December 2019 (in €'000)	Amortised cost	Unrealised gains	Carrying amount	Nominal amount
Short-term, medium-term and long-term tranche	31,699,308	442,403	32,141,711	31,298,338
Hold-to-maturity tranche	1,428,884	-	1,428,884	1,332,059
Total debt securities including fixed income securities	33,128,192	442,403	33,570,595	32,630,397

On 31 December 2020, the amortised cost of the debt securities invested in the Short-term tranche and in the Medium and long-term tranche was €37.5 billion (31 December 2019: €31.7 billion), against a carrying amount at fair value of €38.5 billion (31 December 2019: €32.1 billion). The difference represents the unrealised result and is recognised directly in the equity within the fair value reserve.

The debt securities invested in the Hold-to-maturity tranche are initially recognised at cost and measured subsequently at amortised cost (refer to Note 2.7.1), less impairment where needed.

On 31 December 2020, the total carrying amount of the debt securities in the paid-in capital portfolios was €44.3 billion (31 December 2019: €33.6 billion).

In respect of the paid-in capital portfolio invested in debt securities, the ESM has an established investment policy setting strict eligibility criteria that restrict investment to issuers with the highest credit quality. The ESM's risk management defines a limit structure to mitigate the maximum exposure per issuer.

On 31 December 2020, the debt securities including fixed income securities included also investments in money market securities that were not listed on regulated markets with a total carrying value of €149.5 million (31 December 2019: €156.9 million). Their fair values were determined using valuation techniques, as disclosed in Note 2.7.3. All other securities were listed on regulated markets and the fair values of these assets are based on quoted market prices.

The ESM invests in debt securities issued by public bodies and other issuers. Public bodies include central banks, central governments, regional governments, local governments, supranational institutions and governmental agencies. On 31 December 2020, debt securities issued by public bodies amounted to €22.3 billion (31 December 2019: €14.6 billion), while debt securities issued by other borrowers amounted to €22.0 billion (31 December 2019: €18.9 billion).

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

8. Intangible assets

The following table shows the movements of intangible assets during 2020:

(in €'000)	Software	Total intangible assets
Historical cost		
1 January 2020 balance	200	**200**
Additions	2	**2**
31 December 2020 balance	**202**	**202**
Accumulated amortisation		
1 January 2020 balance	(182)	**(182)**
Amortisation	(13)	**(13)**
31 December 2020 balance	**(195)**	**(195)**
Net book value		
31 December 2020 balance	**7**	**7**
31 December 2019 balance	**18**	**18**

9. Tangible assets

The following table shows the movements of tangible assets during 2020:

(in €'000)	Fixtures and fittings	Furniture and office equipment	Total tangible assets
Historical cost			
1 January 2020 balance	10,445	2,785	13,230
Additions	457	219	666
31 December 2020 balance	10,902	3,004	13,906
Accumulated depreciation			
1 January 2020 balance	(4,651)	(2,105)	(6,756)
Depreciation	(1,403)	(296)	(1,699)
31 December 2020 balance	(6,054)	(2,401)	(8,455)
Net book value			
31 December 2020 balance	4,848	603	5,451
31 December 2019 balance	5,794	680	6,474

10. Prepayments and accrued income

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

(in €'000)	31.12.2020	31.12.2019
Interest receivable on:		
- Debt securities including fixed-income securities	104,390	102,140
- Loans and advances to euro area member states	388,049	395,467
- Loans and advances to credit institutions	328	91
Amounts charged to the EFSF for administrative services (Notes 20/26)	9,540	9,414
Commitment fee receivable	6,590	617
Prepayments	884	842
Prepayments and accrued income on derivatives (1)	389,163	354,537
Total prepayments and accrued income	898,944	863,108

(1) "Prepayments and accrued income on derivatives" represents the spot revaluation, spread amortisation and accrued income of ongoing derivative transactions (refer to Note 2.11).

11. Amounts owed to credit institutions

On 31 December 2020, the €983.0 million (31 December 2019: €331.0 million) of amounts owed to credit institutions were composed of cash collateral received for the derivatives €2.1 million (31 December 2019: €1.3 million) and repurchase agreements ("repo") €980.9 million (31 December 2019: €329.7 million).

12. Debts evidenced by certificates

The following table discloses the details of debt securities in issue outstanding on 31 December 2020, together with the coupon rates and due dates.

Type of funding Programmes	ISIN code	Nominal amount (in €'000)	Issue date	Maturity date	Coupon
Long-term Funding	EU000A1U9803	3,000,000	20/11/2013	20/11/2023	2.125%
Long-term Funding	EU000A1U9803(2)	990,750	27/06/2014	20/11/2023	2.125%
Long-term Funding	EU000A1U9811	6,000,000	04/03/2014	04/03/2021	1.375%
Long-term Funding	EU000A1U9894	3,000,000	23/09/2015	23/09/2025	1.000%
Long-term Funding	EU000A1U9894(2)	999,850	29/09/2016	23/09/2025	1.000%
Long-term Funding	EU000A1U9902	3,000,000	20/10/2015	20/10/2045	1.750%
Long-term Funding	EU000A1U9928	1,500,000	17/11/2015	17/11/2036	1.625%
Long-term Funding	EU000A1U9928(2)	1,000,000	31/03/2016	17/11/2036	1.625%
Long-term Funding	EU000A1U9936	1,000,000	01/12/2015	01/12/2055	1.850%
Long-term Funding	EU000A1U9936(2)	1,000,000	01/03/2016	01/12/2055	1.850%
Long-term Funding	EU000A1U9936(2)	750,000	05/09/2018	01/12/2055	1.850%
Long-term Funding	EU000A1U9944	3,000,000	02/03/2016	02/03/2026	0.500%
Long-term Funding	EU000A1U9944(2)	2,500,000	19/07/2016	02/03/2026	0.500%
Long-term Funding	EU000A1U9951	3,000,000	22/04/2016	22/04/2024	0.125%
Long-term Funding	EU000A1U9951(2)	961,100	28/07/2016	22/04/2024	0.125%
Long-term Funding	EU000A1U9951(2)	989,750	11/11/2016	22/04/2024	0.125%
Long-term Funding	EU000A1U9969	3,000,000	03/05/2016	03/05/2032	1.125%
Long-term Funding	EU000A1U9969(2)	1,000,000	18/10/2016	03/05/2032	1.125%
Long-term Funding	EU000A1U9977	2,500,000	19/07/2016	18/07/2042	0.875%
Long-term Funding	EU000A1U9985(1)	3,000,000	18/10/2016	18/10/2022	0.000%
Long-term Funding	EU000A1U9985(2)	996,500	16/11/2017	18/10/2022	0.000%
Long-term Funding	EU000A1U9985(2)	998,550	23/02/2018	18/10/2022	0.000%
Long-term Funding	EU000A1Z99A1	3,500,000	01/02/2017	02/11/2046	1.800%
Long-term Funding	EU000A1Z99A1(2)	1,500,000	14/06/2017	02/11/2046	1.800%
Long-term Funding	EU000A1Z99B9	3,000,000	14/03/2017	15/03/2027	0.750%
Long-term Funding	EU000A1Z99B9(2)	1,500,000	19/06/2018	15/03/2027	0.750%
Long-term Funding	EU000A1Z99D5	2,000,000	23/05/2018	23/05/2033	1.200%
Long-term Funding	EU000A1Z99E3	4,000,000	31/07/2018	31/07/2023	0.100%
Long-term Funding	EU000A1Z99F0	3,250,000	05/09/2018	05/09/2028	0.750%
Long-term Funding	EU000A1Z99F0(2)	1,500,000	05/09/2018	05/09/2028	0.750%
Short-term Funding	EU000A1Z99G8	1,500,000	14/05/2019	17/01/2022	0.000%
Long-term Funding	EU000A1Z99G8(2)	3,000,000	16/10/2018	17/01/2022	0.000%
Long-term Funding	EU000A1Z99H6	2,000,000	05/03/2019	05/03/2029	0.500%
Long-term Funding	EU000A1Z99H6(2)	1,000,000	14/05/2019	05/03/2029	0.500%
Long-term Funding	EU000A1Z99J2(1)	3,500,000	29/10/2019	14/03/2025	N/A
Long-term Funding	EU000A1Z99K0	3,000,000	17/02/2020	10/02/2023	N/A
Long-term Funding	EU000A1Z99L8	2,000,000	04/03/2020	04/03/2030	0.010%
Long-term Funding	EU000A1Z99M6	2,000,000	26/10/2020	16/12/2024	0.000%
Long-term Funding	XS1704649158(4)	2,444,789	31/10/2017	03/11/2022	2.125%
Long-term Funding	XS2051117195(4)	1,629,859	11/09/2019	11/09/2024	1.375%
Long-term Funding	XS2226989015(4)	2,444,789	10/09/2020	10/09/2025	0.375%
Long-term Funding	ESMNBOND0001(3)	80,000	22/01/2016	22/01/2041	1.572%
Long-term Funding	ESMNBOND0002(3)	30,000	10/02/2016	11/02/2041	1.360%
Long-term Funding	ESMNBOND0003(3)	25,000	09/03/2016	09/03/2056	1.559%

Continued from the previous page

Type of funding Programmes	ISIN code	Nominal amount (in €'000)	Issue date	Maturity date	Coupon
Long-term Funding	ESMNBOND0004[(3)]	25,000	09/03/2016	09/03/2056	1.559%
Long-term Funding	ESMNBOND0005[(3)]	25,000	31/03/2016	22/03/2046	1.316%
Long-term Funding	ESMNBOND0006[(3)]	30,000	11/04/2016	11/04/2046	1.220%
Long-term Funding	ESMNBOND0007[(3)]	40,000	03/08/2016	03/08/2056	1.156%
Long-term Funding	ESMNBOND0008[(3)]	150,000	09/08/2016	09/08/2056	1.150%
Long-term Funding	ESMNBOND0009[(3)]	50,000	19/08/2016	19/08/2053	1.025%
Long-term Funding	ESMNBOND0010[(3)]	50,000	19/08/2016	18/08/2056	1.064%
Long-term Funding	ESMNBOND0011[(3)]	50,000	19/09/2016	19/09/2051	1.030%
Long-term Funding	ESMNBOND0012[(3)]	50,000	19/10/2016	19/10/2054	1.145%
Long-term Funding	ESMNBOND0013[(3)]	40,000	19/10/2016	19/10/2056	1.125%
Long-term Funding	ESMNBOND0014[(3)]	25,000	27/10/2016	27/10/2056	1.086%
Long-term Funding	ESMNBOND0015[(3)]	110,000	14/03/2017	14/03/2047	1.800%
Long-term Funding	ESMNBOND0016[(3)]	40,000	31/03/2017	30/03/2057	1.850%
Long-term Funding	ESMNBOND0017[(3)]	100,000	21/04/2017	21/04/2047	1.573%
Long-term Funding	ESMNBOND0018[(3)]	60,000	27/11/2017	27/11/2057	1.591%
Long-term Funding	ESMNBOND0019[(3)]	25,000	11/12/2017	11/12/2057	1.530%
Long-term Funding	ESMNBOND0020[(3)]	50,000	12/12/2017	12/12/2057	1.505%
Long-term Funding	ESMNBOND0021[(3)]	50,000	19/12/2017	19/12/2057	1.442%
Short-term Funding	EU000A2SB901[(1)]	1,999,760	24/09/2020	18/03/2021	N/A
Short-term Funding	EU000A2SB919[(1)]	1,998,870	08/10/2020	07/01/2021	N/A
Short-term Funding	EU000A2SB927[(1)]	1,499,770	15/10/2020	14/10/2021	N/A
Short-term Funding	EU000A2SB935[(1)]	1,999,910	22/10/2020	22/04/2021	N/A
Short-term Funding	EU000A2SB943[(1)]	1,999,120	05/11/2020	04/02/2021	N/A
Short-term Funding	EU000A2SB950[(1)]	1,490,470	12/11/2020	11/11/2021	N/A
Short-term Funding	EU000A2SB968[(1)]	1,999,700	19/11/2020	20/05/2021	N/A
Short-term Funding	EU000A2SB976[(1)]	1,499,740	03/12/2020	04/03/2021	N/A
Short-term Funding	EU000A2SB9J1[(1)]	1,000,000	17/04/2020	15/04/2021	N/A
Short-term Funding	EU000A2SB9M5[(1)]	1,488,850	14/05/2020	13/05/2021	N/A
Short-term Funding	EU000A2SB9Q6[(1)]	1,499,100	11/06/2020	10/06/2021	N/A
Short-term Funding	EU000A2SB9T0[(1)]	1,498,830	16/07/2020	15/07/2021	N/A
Short-term Funding	EU000A2SB9U8[(1)]	1,993,350	23/07/2020	21/01/2021	N/A
Short-term Funding	EU000A2SB9W4[(1)]	1,499,650	13/08/2020	12/08/2021	N/A
Short-term Funding	EU000A2SB9X2[(1)]	1,999,680	20/08/2020	18/02/2021	N/A
Short-term Funding	EU000A2SB9Z7[(1)]	1,498,700	17/09/2020	16/09/2021	N/A
Total		117,026,437			

[(1)] Zero-coupon bond.
[(2)] Tap issue.
[(3)] N-bond with technical ISIN: the ESM issued its first N-bond (Namensschuldverschreibungen) in 2016. N-Bonds are privately placed, long-term funding instruments that are neither centrally cleared nor listed.
[(4)] USD denominated debt securities issued starting from 2017.
[(5)] The difference with the total amount in the balance sheet comes from the premium and discount amortisations. The debt evidenced by certificates are presented at their amortised cost in balance sheet (Refer to Note 2.13).

The following table discloses the details of debt securities in issue outstanding on 31 December 2019, together with the coupon rates and due dates.

Type of funding Programmes	ISIN code	Nominal amount (in €'000)	Issue date	Maturity date	Coupon
Long-term Funding	EU000A1U9803	3,000,000	20/11/2013	20/11/2023	2.125%
Long-term Funding	EU000A1U9803(2)	990,750	27/06/2014	20/11/2023	2.125%
Long-term Funding	EU000A1U9811	6,000,000	04/03/2014	04/03/2021	1.375%
Long-term Funding	EU000A1U9894	3,000,000	23/09/2015	23/09/2025	1.000%
Long-term Funding	EU000A1U9894(2)	999,850	29/09/2016	23/09/2025	1.000%
Long-term Funding	EU000A1U9902	3,000,000	20/10/2015	20/10/2045	1.750%
Long-term Funding	EU000A1U9910	4,000,000	03/11/2015	03/11/2020	0.100%
Long-term Funding	EU000A1U9910(2)	992,750	11/03/2016	03/11/2020	0.100%
Long-term Funding	EU000A1U9928	1,500,000	17/11/2015	17/11/2036	1.625%
Long-term Funding	EU000A1U9928(2)	1,000,000	31/03/2016	17/11/2036	1.625%
Long-term Funding	EU000A1U9936	1,000,000	01/12/2015	01/12/2055	1.850%
Long-term Funding	EU000A1U9936(2)	1,000,000	01/03/2016	01/12/2055	1.850%
Long-term Funding	EU000A1U9936(2)	750,000	05/09/2018	01/12/2055	1.850%
Long-term Funding	EU000A1U9944	3,000,000	02/03/2016	02/03/2026	0.500%
Long-term Funding	EU000A1U9944(2)	2,500,000	19/07/2016	02/03/2026	0.500%
Long-term Funding	EU000A1U9951	3,000,000	22/04/2016	22/04/2024	0.125%
Long-term Funding	EU000A1U9951(2)	961,100	28/07/2016	22/04/2024	0.125%
Long-term Funding	EU000A1U9951(2)	989,750	11/11/2016	22/04/2024	0.125%
Long-term Funding	EU000A1U9969	3,000,000	03/05/2016	03/05/2032	1.125%
Long-term Funding	EU000A1U9969(2)	1,000,000	18/10/2016	03/05/2032	1.125%
Long-term Funding	EU000A1U9977	2,500,000	19/07/2016	18/07/2042	0.875%
Long-term Funding	EU000A1U9985(1)	3,000,000	18/10/2016	18/10/2022	0.000%
Long-term Funding	EU000A1U9985(2)	996,500	16/11/2017	18/10/2022	0.000%
Long-term Funding	EU000A1U9985(2)	998,550	23/02/2018	18/10/2022	0.000%
Long-term Funding	EU000A1Z99A1	3,500,000	01/02/2017	02/11/2046	1.800%
Long-term Funding	EU000A1Z99A1(2)	1,500,000	14/06/2017	02/11/2046	1.800%
Long-term Funding	EU000A1Z99B9	3,000,000	14/03/2017	15/03/2027	0.750%
Long-term Funding	EU000A1Z99B9(2)	1,500,000	19/06/2018	15/03/2027	0.750%
Long-term Funding	EU000A1Z99D5	2,000,000	23/05/2018	23/05/2033	1.200%
Long-term Funding	EU000A1Z99E3	4,000,000	31/07/2018	31/07/2023	0.100%
Long-term Funding	EU000A1Z99F0	3,250,000	05/09/2018	05/09/2028	0.750%
Long-term Funding	EU000A1Z99G8(1)	3,000,000	16/10/2018	17/01/2022	0.000%
Long-term Funding	EU000A1Z99H6	2,000,000	05/03/2019	05/03/2029	0.500%
Long-term Funding	EU000A1Z99H6(2)	1,000,000	14/05/2019	05/03/2029	0.500%
Long-term Funding	EU000A1Z99J2(1)	3,500,000	29/10/2019	14/03/2025	0.000%
Long-term Funding	XS1704649158(4)	2,670,465	31/10/2017	03/11/2022	2.125%
Long-term Funding	XS2051117195(4)	1,780,310	11/09/2019	11/09/2024	1.375%
Long-term Funding	ESMNBOND0001(3)	80,000	22/01/2016	22/01/2041	1.572%
Long-term Funding	ESMNBOND0002(3)	30,000	10/02/2016	11/02/2041	1.360%
Long-term Funding	ESMNBOND0003(3)	25,000	09/03/2016	09/03/2056	1.559%
Long-term Funding	ESMNBOND0004(3)	25,000	09/03/2016	09/03/2056	1.559%
Long-term Funding	ESMNBOND0005(3)	25,000	31/03/2016	22/03/2046	1.316%
Long-term Funding	ESMNBOND0006(3)	30,000	11/04/2016	11/04/2046	1.220%
Long-term Funding	ESMNBOND0007(3)	40,000	03/08/2016	03/08/2056	1.156%
Long-term Funding	ESMNBOND0008(3)	150,000	09/08/2016	09/08/2056	1.150%
Long-term Funding	ESMNBOND0009(3)	50,000	19/08/2016	19/08/2053	1.025%

Continued from the previous page

Type of funding Programmes	ISIN code	Nominal amount (in €'000)	Issue date	Maturity date	Coupon
Long-term Funding	ESMNBOND0010[3]	50,000	19/08/2016	18/08/2056	1.064%
Long-term Funding	ESMNBOND0011[3]	50,000	19/09/2016	19/09/2051	1.030%
Long-term Funding	ESMNBOND0012[3]	50,000	19/10/2016	19/10/2054	1.145%
Long-term Funding	ESMNBOND0013[3]	40,000	19/10/2016	19/10/2056	1.125%
Long-term Funding	ESMNBOND0014[3]	25,000	27/10/2016	27/10/2056	1.086%
Long-term Funding	ESMNBOND0015[3]	110,000	14/03/2017	14/03/2047	1.800%
Long-term Funding	ESMNBOND0016[3]	40,000	31/03/2017	30/03/2057	1.850%
Long-term Funding	ESMNBOND0017[3]	100,000	21/04/2017	21/04/2047	1.573%
Long-term Funding	ESMNBOND0018[3]	60,000	27/11/2017	27/11/2057	1.591%
Long-term Funding	ESMNBOND0019[3]	25,000	11/12/2017	11/12/2057	1.530%
Long-term Funding	ESMNBOND0020[3]	50,000	12/12/2017	12/12/2057	1.505%
Long-term Funding	ESMNBOND0021[3]	50,000	19/12/2017	19/12/2057	1.442%
Short-term Funding	EU000A1Z99G8[2]	1,500,000	14/05/2019	17/01/2022	0.000%
Short-term Funding	XS1896646137[4]	2,670,465	23/10/2018	23/10/2020	3.000%
Short-term Funding	EU000A2SB810[1]	2,499,760	18/07/2019	23/01/2020	N/A
Short-term Funding	EU000A2SB836[1]	3,493,280	22/08/2019	20/02/2020	N/A
Short-term Funding	EU000A2SB851[1]	2,999,980	19/09/2019	19/03/2020	N/A
Short-term Funding	EU000A2SB869[1]	3,499,200	10/10/2019	09/01/2020	N/A
Short-term Funding	EU000A2SB877[1]	2,994,580	24/10/2019	23/04/2020	N/A
Short-term Funding	EU000A2SB885[1]	2,499,000	07/11/2019	06/02/2020	N/A
Short-term Funding	EU000A2SB893[1]	2,499,090	21/11/2019	21/05/2020	N/A
Short-term Funding	EU000A2SB9A0[1]	2,497,750	05/12/2019	05/03/2020	N/A
Total[5]		**110,138,130**			

[1] Zero-coupon bond.
[2] Tap issue.
[3] N-bond with technical ISIN: the ESM issued its first N-bond (Namensschuldverschreibungen) in 2016. N-Bonds are privately placed, long-term funding instruments that are neither centrally cleared nor listed.
[4] USD denominated debt securities issued starting from 2017.
[5] The difference with the total amount in the balance sheet comes from the premium and discount amortisations. The debt evidenced by certificates are presented at their amortised cost in balance sheet (Refer to Note 2.13).

The following table shows the movements of the debt securities in issue in 2019 and 2020:

(in €'000)	
1 January 2019 balance	**98,393,959**
Issuance during the period	65,756,716
Maturities during the year	(53,673,530)
Exchange adjustments	63,221
Premiums/discounts amortisation	(127,272)
31 December 2019 balance	**110,413,094**

(in €'000)	
1 January 2020 balance	**110,413,094**
Issuances during the year	71,664,572
Maturities during the year	(63,785,109)
Exchange adjustments	(607,557)
Premiums/discounts amortisation	(173,655)
31 December 2020 balance	**117,511,345**

All debt securities in issue on 31 December 2019 and 31 December 2020 are issued under English law as the governing law, except the N-bonds which are issued under German law. The euro-denominated debt securities in issue on 31 December 2020 are issued under Luxembourgish law.

13. Other liabilities

On 31 December 2020, the other liabilities were composed of suppliers' invoices and staff cost related payables not yet settled, amounting to €11.6 million (31 December 2019: €10.8 million).

14. Accruals and deferred income

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

(in €'000)	31.12.2020	31.12.2019
Interest payable cash and cash equivalents	25,344	28,338
Interest payable on loans to credit institutions	4,399	2,555
Interest payable on debts evidenced by certificates	284,593	294,671
Deferred income on up-front service fee	138,103	185,512
Accruals and deferred income on derivatives(1)	901,037	825,710
Total accruals and deferred income	1,353,476	1,336,786

(1) "Accruals and deferred income on derivatives" represent the spot revaluation, spread amortisation and accrued expense of ongoing derivative transactions (refer to Note 2.15 and 2.5).

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

15. Subscribed capital

(in €'000)	Subscribed capital	Subscribed, uncalled capital	Subscribed, called capital
1 January 2019	704,798,700	(624,250,300)	80,548,400
Subscription to the authorised capital	-	-	-
Authorised capital calls	-	-	-
31 December 2019	704,798,700	(624,250,300)	80,548,400

(in €'000)	Subscribed capital	Subscribed, uncalled capital	Subscribed, called capital
1 January 2020	704,798,700	(624,250,300)	80,548,400
Subscription to the authorised capital	-	-	-
Authorised capital calls	-	-	-
31 December 2020	704,798,700	(624,250,300)	80,548,400

On 31 December 2020, the ESM's shareholders were the 19 euro area member states. The contribution key for subscribing to the ESM authorised capital is based on the key for subscription, by the national central banks of the ESM Members, of the ECB's capital.

Latvia joined the ESM on 13 March 2014 and subscribed to an authorised capital of 19,353 shares with a par value of €100,000 each, representing €1.9 billion of subscribed capital of which €221.2 million was called. On 31 December 2018 Latvia had made all instalments for the payment of paid-in shares. Lithuania joined the ESM on 3 February 2015 and subscribed to an authorised capital of 28,634 shares with a par value of €100,000 each, representing €2.9 billion of subscribed capital, of which €327.2 million was called. On 31 December 2019 Lithuania had made all instalments for the payment of paid-in shares.

On 31 December 2020, the authorised capital was €704.8 billion (31 December 2019: €704.8 billion), divided into 7,047,987 shares (31 December 2019: 7,047,987 shares), with a par value of €100,000 each, and is split according to the contribution key. Out of the total authorised capital, €624.3 billion (31 December 2019: €624.3 billion) is callable. On 31 December 2020, the total called subscribed capital amounted to €80.5 billion is paid (31 December 2019: €80.5 billion).

ESM Members 31 December 2020	ESM Key (%)	Number of shares	Subscribed capital (in €'000)	Subscribed capital called and paid (in €'000)
Federal Republic of Germany	26.9449	1,899,071	189,907,100	21,703,670
French Republic	20.2346	1,426,131	142,613,100	16,298,640
Italian Republic	17.7807	1,253,184	125,318,400	14,322,100
Kingdom of Spain	11.8153	832,743	83,274,300	9,517,060
Kingdom of the Netherlands	5.6746	399,945	39,994,500	4,570,800
Kingdom of Belgium	3.4513	243,244	24,324,400	2,779,930
Hellenic Republic	2.7957	197,044	19,704,400	2,251,930
Republic of Austria	2.7627	194,718	19,471,800	2,225,350
Portuguese Republic	2.4906	175,534	17,553,400	2,006,100
Republic of Finland	1.7841	125,744	12,574,400	1,437,070
Ireland	1.5804	111,383	11,138,300	1,272,960
Slovak Republic	0.8184	57,680	5,768,000	659,200
Republic of Slovenia	0.4678	32,973	3,297,300	376,830
Republic of Lithuania	0.4063	28,634	2,863,400	327,200
Republic of Latvia	0.2746	19,353	1,935,300	221,200
Grand Duchy of Luxembourg	0.2486	17,519	1,751,900	200,220
Republic of Cyprus	0.1948	13,729	1,372,900	156,900
Republic of Estonia	0.1847	13,020	1,302,000	148,800
Republic of Malta	0.0899	6,338	633,800	72,440
Total	**100.00**	**7,047,987**	**704,798,700**	**80,548,400**

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

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

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

  - to cover a shortfall due to a non-payment by a beneficiary country and,

  - if losses occurring due to other factors reduce the countervalue of the paid-in capital below the threshold of 15% of the maximum lending volume of the ESM.

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

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

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

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

16. Reserve fund

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

On 11 June 2020, the Board of Governors decided at their annual general meeting to appropriate the net result of 2019 amounting to €289.7 million to the reserve fund. As a result the outstanding balance of the reserve fund as at 31 December 2020 is €2.6 billion (31 December 2019: €2.3 billion).

17. Interest receivable and similar income on loans and advances to euro area member states

Interest receivable and similar income on loans and advances to euro area member states are detailed as follows:

(in €'000)	2020	2019
Interest on loans [(1)]	1,073,153	1,101,597
Amortisation up-front service fee	47,408	76,667
Commitment fee	6,590	617
Total interest and similar income	**1,127,151**	**1,178,881**

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

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

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

(in €'000)	2020	2019
Euro area issuers	52,070	55,842
Other EU issuers	10,011	4,224
EU supranational organisations	12,443	12,890
Total European Union	**74,524**	**72,956**
Other non-EU issuers	22,279	26,808
Other supranational organisations	24,702	14,680
Total outside the European Union	**46,981**	**41,488**
Total interest and similar income	**121,505**	**114,444**

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

On 31 December 2020, the interest payable and similar charges on cash and cash equivalents represents negative interest paid for the balances with central banks and amounts to €309.2 million (2019: €285.8 million). The ESM was charged a negative interest rate of - 0.40% per annum on the cash held at national central banks from February 2017 to September 2019. Since September 2019, the ESM is being charged a negative interest rate of -0.50% per annum. In order to limit the negative implications on ESM's paid-in capital, some member states have compensated the ESM for the amount charged by their national central banks on the part of ESM paid-in capital that is held by them in cash deposits. The compensation has been recorded as an extraordinary income (refer to Note 24).

20. Other operating income

The EFSF has asked the ESM to provide administrative and other support services to assist it in performing its activities. To formalise this cooperation, the ESM and EFSF entered into a service level agreement (SLA) from 1 January 2013. On 17 July 2020, the fees calculation section of the Annex to the SLA between the EFSF and the ESM has been amended to reflect the level of activity for cost allocations between the two institutions. Under the amended agreement's terms, the ESM is entitled to charge the EFSF service fees to achieve a fair cost-sharing arrangement. For the services rendered during the financial year 2020, the ESM charged the EFSF €33.1 million (2019: €33.1 million), from which €9.5 million (2019: €9.4 million) had yet to be paid on the balance sheet date (refer to Note 10).

In 2020, the internal tax on salaries retained from staff members amounts to €1.9 million (2019: €1.7 million). Salaries are recorded on a gross basis within staff costs. In accordance with Article 36(5) of the ESM Treaty, such internal tax is for the benefit of the ESM.

21. Net profit on financial operations

Net profit on financial operations is detailed as follows:

(in €'000)	2020	2019
Net realised result of sales of debt securities	208,289	63,857
Net foreign exchange result	3	(9)
Total net result on financial operations	**208,292**	**63,848**

The net realised result of sales of debt securities reflects gains and losses realised at the date of derecognition of the respective financial assets. Up to that date, the debt securities as part of the Short-term tranche and the Medium and long-term tranche of the paid-in capital portfolio are carried at fair value and unrealised gains and losses are recorded in the equity within the fair value reserve.

22. Staff costs

Staff costs are detailed as follows:

(in €'000)	2020	2019
Salaries[(1)] and allowances	26,721	24,012
Social security costs	1,203	1,204
Pension costs	8,924	7,751
Total staff costs	**36,848**	**32,967**

[(1)] Of which €1.98 million (31 December 2019: €1.71 million) relate to the ESM Management Board members, including €0.38 million (2019: €0.37 million) to the ESM Managing Director.

The ESM employed 203 persons on 31 December 2020 (186 on 31 December 2019).

In addition to its own employees, the ESM has expenses for employees seconded from other international financial institutions, as well as interim and temporary staff hired from external agencies. The related costs amount to €1.9 million for the 2020 financial year (2019: €2.1 million) and are accounted for as 'Other administrative expenses' (refer to Note 23).

The pension costs represent the ESM's contributions during the financial year to the outsourced employee retirement plan.

Social security costs include the ESM's contributions during the financial year to the health care scheme and for death and disability coverage, which is outsourced to external insurance companies.

23. Other administrative expenses

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

(in €'000)	2020	2019
Outsourced services (mainly IT, HR and accounting services)	11,951	10,955
Advisory services	10,206	8,291
Rental and office building related services	5,557	5,726
IT hardware	2,982	2,561
Other services	2,657	5,110
Treasury related services	2,582	2,029
Interim and secondment fees (Note 22)	1,859	2,110
Legal services	967	1,104
Rating agencies fees	453	765
Total other administrative expenses	**39,214**	**38,651**

24. Extraordinary income

In 2020, the extraordinary income, totaling €235.7 million, was composed of the amounts received from the Federal Republic of Germany, the French Republic and the Italian Republic, to compensate the ESM for a part of the negative interest charged on the cash held at their national central banks during 2019. These represent €131.7 million, €98.0 million and €6.0 million respectively.

In 2019, the extraordinary income, totaling €237.9 million, was mainly composed of negative interest compensation on the cash held at the national central banks during 2018. These represented €135.4 million on behalf of the Federal Republic of Germany and €102.5 million from the French Republic.

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

25. Derivatives

The ESM uses derivatives for risk management purposes, as described in Note 2.5. Since 2015, the ESM has been entering into foreign exchange derivative transactions such as foreign exchange swaps and foreign exchange forward contracts to hedge the currency risk related to short-term non-euro denominated investments. Starting from 2017, the ESM has entered into interest rate swaps and cross-currency asset swaps for the purpose of managing interest rate risk on euro and non-euro denominated issued debt, as well as euro and non-euro denominated investments. Since 2019, the ESM started to use also bond futures and since 2020 interest rate futures to manage the interest rate risk of the paid-in capital portfolio.

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

On 31 December 2020, the derivative financial instruments had a maximum maturity up to 30 years (31 December 2019: maximum maturity up to 29 years) and were concluded with euro area central banks, international financial institutions or commercial banks.

The following table discloses the details of result on derivative contracts during the year ending on 31 December 2020.

(in €'000)	Interest receivable and similar income	Interest payable and similar charges	Net result
Interest result on interest rate swaps [1]	230,438	(602,946)	(372,508)
Interest result on cross-currency asset swaps	180,836	(111,605)	69,231
Up-front payments on cross-currency asset swaps	37,618	(3,349)	34,269
Up-front payments on unwind cross-currency asset swaps	3,191	(712)	2,479
Unwind result on cross-currency asset swaps	1,350	(4,222)	(2,872)
Spread on foreign exchange swaps	-	(467)	(467)
Unwind result on interest rate swaps	2,125	(2,465)	(340)
Result on futures	4,968	-	4,968
Total	**460,526**	**(725,766)**	**(265,240)**

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

The following table discloses the details of result on derivative contracts during the year ending on 31 December 2019.

(in €'000)	Interest receivable and similar income	Interest payable and similar charges	Net result
Interest result on interest rate swaps [1]	210,118	(572,685)	(362,567)
Interest result on cross-currency asset swaps	170,964	(93,702)	77,262
Up-front payments on cross-currency asset swaps	41,682	(3,456)	38,226
Spread on foreign exchange swaps	301	(344)	(43)
Unwind result	5	(872)	(867)
Result on futures	391	-	391
Total	**423,461**	**(671,059)**	**(247,598)**

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

The realised part included in 'Interest receivable and similar income' amounts to €460.5 million (31 December 2019: €367.2 million), while for 'Interest payable and similar charges' this represents €725.8 million (31 December 2019: €644.9 million).

26. Related-party transactions

KEY MANAGEMENT

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

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

TRANSACTIONS WITH SHAREHOLDERS

The ESM granted loans to Spain, Cyprus and Greece, which are also ESM shareholders, as disclosed in more detail in Note 6. In the course of its investment activity, the ESM purchases debt securities issued by its shareholders. Such securities are reported as 'Debt securities including fixed-income securities' on the balance sheet. On 31 December 2020, the total carrying amount of purchased securities issued by shareholders of the ESM was €3.2 billion (31 December 2019: €3.4 billion).

In 2017 member states expressed their willingness to compensate the ESM up to the amount of negative interest charged by their national central banks with the intention to limit the negative implications on ESM's paid-in capital. The transfers were made under certain conditions and following parliamentary approval. In 2020 and 2019, the ESM received payments from French Republic, Federal Republic of Germany and Italian Republic to compensate for the negative interest charged on the cash balances held with their respective national central banks (refer to Note 24).

On 11 February 2020, €131.7 million was received from Germany, on 3 July 2020, €6.0 million was received from Italy and on 18 November 2020, the ESM received €98.0 million from France. These amounts were recorded as extraordinary income in 2020 (refer to Note 24).

TRANSACTIONS WITH THE EUROPEAN FINANCIAL STABILITY FACILITY (EFSF)

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

The EFSF was created as a temporary rescue mechanism. In accordance with its Articles of Association, the EFSF will be dissolved and liquidated when all financial assistance provided to euro area member states and all funding instruments issued by the EFSF have been repaid in full. As of 1 July 2013, the EFSF may no longer engage in new financing programmes or enter into new loan facility agreements.

The EFSF has asked the ESM to provide certain administrative services and other support services to facilitate the performance of its activities. To formalise this cooperation, the two institutions have entered into a service level agreement. In 2020, the SLA Annex has been amended to reflect the level of activity for cost allocations between the two institutions, which does not result in a material difference in the current year compared to 2019. In line with the terms of this agreement, the ESM charged the EFSF €33.1 million for the financial year 2020 (31 December 2019: €33.1 million), from which €9.5 million (31 December 2019: €9.4 million) had not yet been paid at balance sheet date (refer to Note 10). The ESM recognised these amounts as other operating income in the profit and loss account.

27. Audit fee

The total fees accrued in 2020 by the ESM to Ernst & Young, Société Anonyme are presented as follows:

(in €'000)	2020	2019
Audit fees	275	249
Audit related fees	92	136
Total audit fees	**367**	**385**

In 2020 and 2019, the external auditors provided the ESM with audit-related services in relation with the US-dollar denominated bond issuance. In 2019, such fees were also paid to PriceWaterhouseCoopers in their capacity as former external auditors.

28. Events after the reporting period

There have been no material post balance sheet events which could require disclosure or adjustment to the 31 December 2020 financial statements.

05 External auditor's report on the 2020 financial statements

To the Board of Governors of European Stability Mechanism

Report on the audit of the financial statements

Opinion

We have audited the financial statements of European Stability Mechanism (the "Entity" or "ESM"), which comprise the balance sheet as at 31 December 2020, the profit and loss account, the statement of changes in equity and the statement of cash flows for the year then ended, and the notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements give a true and fair view of the financial position of the Entity as at 31 December 2020, and of the results of its operations and its cash flows for the year then ended in accordance with the general principles of the Directive 86/635/EEC of the Council of the European Communities of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions, as amended by Directive 2001/65/EC of 27 September 2001, by Directive 2003/51/EC of 18 June 2003 and by Directive 2006/46/EC of 14 June 2006 (the "Directives").

Basis for opinion

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

Key audit matters

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

Impairment of loans and advances

As at 31 December 2020, the loans and advances to euro area Member States amounted to EUR 89.9 billion and related to financial assistance granted to Spain, Cyprus and Greece in line with ESM's mission to provide financial assistance to euro area countries experiencing or threatened by severe financing problems. These loans were granted to recapitalise banks in Spain, and as part of a macroeconomic adjustment programme in the case of Cyprus and Greece. For the year ending 31 December 2020, no impairment has been recorded by ESM on these outstanding loans.

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

To assess the required impairment allowance and in accordance with article 13(6) of the ESM Treaty - the ESM shall establish an appropriate warning system to ensure that it receives any repayments due by the ESM Member under the stability support in a timely manner - ESM assesses individually each loan and advance granted to the beneficiary ESM Members on a regular basis through the analysis of the main following indicators of the beneficiary country:

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

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

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

How the matter was addressed in our audit

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

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

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

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

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

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

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

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

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

We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Entity's internal control.

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the Board of Directors.

- Conclude on the appropriateness of Board of Directors' use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Entity's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our report of the "réviseur d'entreprises agréé" to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our report of the "réviseur d'entreprises agréé". However, future events or conditions may cause the Entity to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

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

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

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

Report on other legal and regulatory requirements

In 2017, the Board of Governors had appointed Ernst & Young as the ESM's external auditor for a three-year term, renewable once. We have been re-appointed as "réviseur d'entreprises agréé" by the Board of Governors on 11 June 2020 for a three-year term and the duration of our uninterrupted engagement, including previous renewals and reappointments, is four years.

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

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

Ernst & Young
Société anonyme
Cabinet de révision agréé

Bernard Lhoest | Papa Saliou Diop
Luxembourg, 30 March 2021

06 Report of the Board of Auditors on the 2020 financial statements

Luxembourg, 30 March 2021

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.[9]

This Board of Auditors report in respect of the financial statements is addressed to the Board of Governors in accordance with Article 23 (2) (d) of the ESM By-Laws. It is delivered in respect of the financial statements of the ESM for the year ended 31 December 2020.

The Board of Auditors notes that based on its own work and considering the work of the external auditor, to the best of its judgment, no material matters have come to its attention that would prevent it from recommending that the Board of Governors approve the financial statements of the ESM for the year ended 31 December 2020.

On behalf of the Board of Auditors

Baudilio Tomé Muguruza
Chairperson

[9] The Board of Auditors carries out independent audits of regularity, compliance, performance and risk management of the ESM, inspects the ESM accounts, and monitors and reviews the ESM's internal and external audit processes and their results. Information on the audit work of the Board of Auditors, its audit findings, conclusions and recommendations for the year ended 31 December 2020 will be included in the annual report, to be prepared in accordance with Article 24(6) of the ESM By-Laws and submitted to the Board of Governors.

Acronyms and abbreviations

ALM	Asset and Liability Management
BPs	Basis points
BoA	Board of Auditors
BoD	Board of Directors
BoG	Board of Governors
BRC	Board Risk Committee
CSA	Credit Support Annex
ECB	European Central Bank
EIB	European Investment Bank
ECCL	Enhanced Conditions Credit Line
EFSF	European Financial Stability Facility
ESG	Environmental, Social and Governance
ESM	European Stability Mechanism
EU	European Union
FFA	Financial Assistance Facility Agreement
FROB	Fondo de Reestructuración Ordenada Bancaria
FX	Foreign exchange
GDP	Gross domestic product
GFSN	Global Financial Safety Net
ICMA	International Capital Market Association
IMF	International Monetary Fund
IRC	Internal Risk Committee
ISDA	International Swaps and Derivatives Association
NPL	Non-performing loan
PCCL	Precautionary Conditioned Credit Line
PDMA	Public Debt Management Agency
RFA	Regional Financing Arrangements
SRB	Single Resolution Board
SRF	Single Resolution Fund
TFEU	Treaty on the Functioning of the European Union
UN-PRI	United Nations Principles for Responsible Investment
USD	US dollar
VaR	Value at Risk

EURO AREA

COUNTRY CODE	COUNTRY NAME
BE	Belgium
DE	Germany
EE	Estonia
IE	Ireland
EL	Greece
ES	Spain
FR	France
IT	Italy
CY	Cyprus
LV	Latvia
LT	Lithuania
LU	Luxembourg
MT	Malta
NL	Netherlands
AT	Austria
PT	Portugal
SI	Slovenia
SK	Slovakia
FI	Finland

NON-EURO AREA

COUNTRY CODE	COUNTRY NAME
UK	United Kingdom
US	United States

EUROPEAN STABILITY MECHANISM

6a Circuit de la Foire Internationale
L-1347 LUXEMBOURG
Tel: (+352) 260 962 0

info@esm.europa.eu
www.esm.europa.eu

Publications Office
of the European Union