European Stability Mechanism

2021 Annual Report

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2021
Annual Report

Letter of transmittal to the Board of Governors

16 June 2022

Dear Chairperson,

I have the honour of presenting to the Board of Governors (BoG) the annual report in respect of the financial year 2021, 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 2021. It also contains the audited financial statements as at 31 December 2021, as drawn up by the Board of Directors (BoD) on 28 March 2022 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

Note: The description of ESM policies and activities covers the 2021 financial year, except when stated otherwise. The information related to the composition of the BoG, BoD, and BoA reflects their composition as of 27 April 2022. The economic development report (Chapter 1) includes certain information available up to 29 April 2022, but all historical financial data are limited to the period to 31 December 2021.

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. The ESM raises funds by issuing debt instruments in the capital markets, which are purchased by institutional investors.

On 30 November 2020, the Eurogroup agreed to proceed with the reform of the ESM. The reform includes the refining of ESM precautionary instruments, enhancing the ESM's role in programme management associated with financial assistance, and providing a common backstop for the Single Resolution Fund (SRF). It will come into force following the ratification of the amended ESM Treaty by all 19 ESM Members.

The ESM grants financial assistance to ESM Members in exchange for a commitment to strengthen economic and financial fundamentals, in line with the financial assistance instrument chosen. The ESM has a number of financial assistance instruments:

- loans to cover ESM Members' 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.

Following the amended ESM Treaty ratification, the common backstop for the SRF will replace the direct bank recapitalisation instrument. The ESM will be able to disburse up to €68 billion under this credit line if the SRF is depleted and certain other criteria are fulfilled.

The ESM has used two financial assistance instruments to date: ESM loans and loans to recapitalise financial institutions. In total together, the ESM and its predecessor the European Financial Stability Facility (EFSF) have disbursed €295 billion to five programme countries: Ireland, Greece, Spain, Cyprus, and Portugal.

For more information about the ESM, visit www.esm.europa.eu.

2021 year in review

11.01
The EFSF kicks off 2021 with a record €70 billion order book on a dual bond transaction.

27.01
ESM Members, represented by their Ambassadors to the EU, sign the Agreement Amending the Treaty Establishing the ESM. Due to a change of government, Estonia signs on 8 February.

04.02
EFSF BoD approves fourth successive reduction of step-up interest margin accrued by Greece from 17 June to 31 December 2020, as part of medium-term debt relief measures agreed for the country in 2018, saving Greece €122.5 million.

04.03
ESM and EFSF BoD agree to waive Greece's mandatory repayment obligation of ESM/EFSF loans tied to its early repayment to the International Monetary Fund (IMF).

14.06
ESM co-organises third annual Capital Markets Seminar with the European Investment Bank (EIB) and the European Commission, attracting nearly 1,000 investors from 30 countries.

17.06
ESM BoG holds its ninth Annual Meeting, approves the 2020 Annual Report, and discusses the main developments and key activities at the ESM over the past year, including its response to the Covid-19 pandemic and the ESM Treaty reform and new mandate. The BoG also benefits from a virtual address by IMF Managing Director Kristalina Georgieva.

30.06
EFSF BoD approves reduction to zero of the step-up margin accrued by Greece from 1 January to 17 June 2021 as part of the medium-term debt relief measures agreed in 2018, saving Greece €103.3 million.

24.07
In close coordination with the ESM, Luxembourg's Ministry of Mobility and Public Works launches a Europe-wide competition for the design of a new headquarters for the ESM in Luxembourg.

24.09
ESM co-organises the 5th Regional Financing Arrangements Research Seminar, centred on debt and growth in the post-pandemic world, in partnership with the Italian G20 Presidency.

30.09
ESM BoG appoints Akis Kikas and Jochen Wenz to the ESM BoA for three-year non-renewable terms, starting on 8 October.

12.10
The 6th High-level Regional Financing Arrangements Dialogue, co-organised by the ESM, takes place.

31.12
ESM increases its hold-to-maturity tranche to €9.9 billion and its holdings in Environmental, Social, and Governance (ESG)-themed bonds to €8 billion by year end.

"Ten years after its creation, the ESM is poised to play a stronger role in crisis prevention and remains ready to assist in current and future crises as part of an overarching euro area commitment to stand united."

KLAUS REGLING
Managing Director
European Stability Mechanism

Message from the Managing Director

The ESM and its temporary predecessor the EFSF were set up to aid euro area countries in avoiding and overcoming financial crises and maintaining financial stability. Since the inception of the crisis mechanisms, the euro area has undergone a series of crises, each of a different nature but all providing lessons for the future. Through it all, the ESM has carried out its mission by providing billions in financial assistance to five member states during the euro debt crisis and by creating its Pandemic Crisis Support tool, an offer to help finance Covid-19 pandemic-related healthcare costs.

Now, we face a new crisis with a devastating war at our doorstep. Beyond the tragic loss of lives, the war in Ukraine also reintroduces a high degree of uncertainty – not only about how our economies will be affected, but also about how this war could lead to a new world order with potentially long-lasting political and economic consequences. Against this backdrop, the EU and euro area will need to ramp up cooperation and increase their resilience.

The ESM is poised to play a stronger role in crisis prevention and future economic adjustment programmes and provide a backstop for the SRF, once the new ESM Treaty is ratified. It remains ready to assist in current and future crises as part of an overarching euro area commitment to stand united.

The euro overcomes its most severe test to date

In 2010, the euro debt crisis brought several euro area member states to the brink of bankruptcy. In some countries, healthy banks struggled with large amounts of debt from their increasingly insolvent sovereigns. In others, badly managed banks bailed out with public money worsened public finances. This 'doom loop' threatened the integrity of our monetary union.

Several factors proved essential in overcoming this crisis.

First, the programme countries took the necessary measures to fix their economies, implementing important reforms, regaining competitiveness, and considerably improving their public finances. Through these efforts, they recovered market participants' trust and thereby market access.

Second, the newly created EFSF and ESM provided lending to those euro area member states that had lost or nearly lost market access. Although the adjustment programmes and attached conditionality did create hardship, they were key in helping address the root causes of economic problems accrued over time and in preserving the integrity of the euro area.

Third, the European Central Bank (ECB), through exceptional monetary policy measures, helped restore the transmission mechanism of the single monetary policy, alleviate the pressure several member countries were facing to refinance themselves, and regain market confidence.

Today, the adjustment programmes for the five countries that received financial assistance totalling nearly €300 billion from the EFSF and the ESM are seen as success stories. Thanks to their high credit ratings, the rescue funds have been able to tap the markets at very favourable conditions and onlend the proceeds to programme countries – at no cost to taxpayers. These favourable lending terms continue to generate substantive budgetary savings for former programme countries and make their debt more sustainable.

Reforms born of crises

Though painful, crises also offer opportunities for change. As we have seen over the past decade, crises can be very different in nature and thus require different solutions – something to bear in mind for any future crises, which may be as unexpected as the ones we have faced to date. During the last decade, crises have triggered significant institutional innovations and led to the creation of banking union and progress in deepening Economic and Monetary Union (EMU).

The euro crisis has shown the clear political commitment to safeguard the integrity of the euro area. It has led to the creation of firewalls, non-conventional monetary policy measures, stronger banking supervision, and the emergence of macroprudential surveillance and policies. Despite undeniable hardship, countries have been able to implement important reforms to reduce macroeconomic imbalances and improve public finances.

Then, in 2020, the Covid-19 crisis again tested the EU and euro area's resilience. The pandemic has caused immense human and economic distress and brought about a deep recession, but it has also been a testimony to the EU's priority to protect human lives while simultaneously reducing the economic fallout through several measures. It has demonstrated the importance and effectiveness of rapid and well-coordinated cooperation at both national and European levels.

The Covid-19 crisis has reminded us that a symmetric economic shock can have a substantial asymmetric impact on countries and require special efforts for those countries most affected by the crisis to protect the single market and the functioning of the monetary union.

The Next Generation EU (NGEU) package could rely on the experience of the EFSF and the ESM by issuing highly rated bonds and using the proceeds to support beneficiary countries. The activation of the Stability and Growth Pact's escape clause created breathing space and allowed for bold fiscal action at the national level.

The cause of this crisis has been very different compared to the euro crisis. Hence, adopting a new approach to solving the shock was appropriate.

The war in Ukraine – a grave new crisis

The war in Ukraine has shocked the world. In addition to the tragic human toll, it has caused massive displacements and destruction. Inevitably, economic growth in the euro area, which was on a strong recovery trajectory after the most severe period of the pandemic, has been revised downward. The conflict has caused high uncertainty about future economic developments by exacerbating the disruption of supply chains and contributing to higher inflation, already seen in the sharp increase in energy and food prices. The economic impact of the conflict could be long-lasting.

A deterioration in the terms of trade, when import prices increase more than export prices, generates losses in wealth and real income. For energy-importing countries, the increase in energy prices brings about a transfer of income and wealth abroad. For the euro area, this loss amounted to about 2.5% of GDP up to the first quarter of 2022, the biggest terms of trade loss on record.

This war has triggered awareness about the need to reduce dependency on energy imports and to diversify energy sources, underscoring the need to push ahead with the green energy transition. This war could also be the trigger for more far-reaching changes, like the shaping of a new economic world order that could reduce globalisation and change trading flows.

Against this backdrop, cooperation within Europe should increase further.

Additional steps needed to strengthen the euro area architecture

In that context, I hope that additional steps to strengthen the EMU architecture will become possible during the next decade, despite the current lack of consensus among member states. At the end of my mandate at the EFSF and the ESM, and after four decades of working on monetary integration in Europe, I believe that progress in the following areas would make EMU more resilient.

First, the completion of banking union. This will require the implementation of several initiatives, including some form of a European deposit insurance scheme. If depositors across the euro area are unevenly protected in the face of a major crisis, the euro does not carry the same value across our monetary union – something misaligned with the spirit underpinning a single currency. Depositors should be protected equally, no matter where they are located.

Second, more progress on establishing a capital markets union. A deep and integrated capital markets union will be essential to generate substantial private investments – complementing public investments – to transform our economies and boost their growth potential. Currently, 19 domestic capital markets coexist in EMU. Ambitious steps towards integration are needed to achieve a single market for capital. This will require major changes, such as harmonising parts of national insolvency laws. While difficult, this endeavour will contribute to better allocation of capital across the EU, strengthening potential growth and increasing risk-sharing via markets, which would reduce fragmentation and promote convergence within the euro area.

Completing banking union and capital markets union would also bolster the international role of the euro. Such a greater role could also be supported by a larger pool of common euro-denominated safe assets. This, in turn, would make banks less vulnerable to sovereign risk by allowing them to substitute some domestic government debt holdings with European safe assets. Such diversification would help lessen the spillover of risks between sovereigns and banking sectors and so help address the 'doom loop'.

Third, a central fiscal capacity for macroeconomic stabilisation. The response to the pandemic was effective and constituted a remarkable act of solidarity, but the nature of the pandemic crisis differed from the previous debt crisis and from the current conflict-induced crisis. In the pandemic crisis, member countries were not suffering from macroeconomic imbalances but were instead hit by a symmetric shock, and all benefitted from a large, but temporary, pan-European support package.

Without further reform of EMU, euro area member states remain vulnerable to asymmetric shocks. As they are part of a monetary union, the only macroeconomic lever to counteract an asymmetric shock is fiscal policy. Without the possibility of receiving additional financial resources from the European level, domestic fiscal space could be insufficient to withstand such a shock and leave a country stranded.

Thus, there is a strong case for introducing a central fiscal capacity to make the euro area more resilient by providing macroeconomic stabilisation and increasing public risk-sharing. It could be designed as a revolving fund, without necessitating additional transfers from member states. The ESM could add such an instrument to its toolbox, drawing on its existing infrastructure and financial resources.

Finally, a reform of the EU fiscal rules that provide an essential coordination framework for the monetary union.

The European Commission has launched a public consultation on the EU economic governance framework, which includes a review of the EU fiscal framework.

When reviewing these rules, we should keep two key aspects in mind: their ultimate objective and our current economic environment. The ultimate objective is clearly debt sustainability, from which no other objective should detract. The current economic environment is very different from the one that existed three decades ago, when the Maastricht Treaty was crafted.

As interest rates are expected to remain below historic levels, the debt-carrying capacity of member countries has increased without putting debt sustainability at risk.

The fiscal rules would become more credible if they reflected this new economic context. The continued application of current rules seems unrealistic and would necessitate permanent exceptions, undermining the credibility of the framework. However, the deficit rule prohibiting yearly deficits of more than 3% of GDP should be kept. Even if not perfect, it has proved its worth by helping keep deficits in check over time. Nevertheless, the fiscal framework should be based on simple and measurable criteria to help increase transparency.

ESM equipped for future uncertainty

Ten years after its creation, the ESM is entering a new phase. Early last year, ESM member countries signed an agreement amending the ESM Treaty, which provides the legal basis for the ESM to perform new tasks. This reform had initially been endorsed by the Heads of State in December 2018 and by the Eurogroup in November 2020. Upon ratification of the reformed treaty, the ESM will play a stronger role in preparing and monitoring potential future programmes and enhance its precautionary credit lines by making their eligibility process more transparent and predictable. Most importantly, the ESM is operationally ready to provide the backstop for the SRF, effectively doubling the SRF's resources should they become depleted. Hence, the credit line provided by the ESM will only be used as a last resort during a severe crisis. The loan would be paid back within three to five years through contributions by banks, thereby guaranteeing its fiscal neutrality. The nominal cap of ESM loans to the SRF has been set at €68 billion. Once the backstop to the SRF becomes effective, the ESM will remove the direct recapitalisation instrument for banks from its toolbox.

Through much effort, trials, errors, and commitment, the euro area and its currency have remained strong and look toward a promising future, especially if it focuses on fortifying its resilience. The ESM has been equipped for the future and, as in the past, stands ready to contribute to safeguarding financial stability in the euro area.

ESM pursues interinstitutional collaboration for the common good

Since its beginnings, the ESM has recognised the value of collaborating with stakeholders beyond regular interactions with Members and investors. The ESM's predecessor, the EFSF, was established with the help of vital services provided by the EIB. Loyal to this collaborative spirit, the ESM has since continued to expand its network, leveraging on the experience and comparative advantage of key counterparts to improve operations and support other institutions with its expertise.

Today, the ESM cooperates with a wide range of institutions and forums at global, regional, and national levels. These include European institutions and bodies; international organisations such as the IMF; Regional Financing Arrangements and multilateral development banks; policy coordination platforms such as the G20 International Financial Architecture Working Group; and knowledge centres like think tanks and academia.

Cooperation with counterparts is paramount for delivering on the ESM's mandate, especially when extending financial assistance to Members. Other elements of ESM's business also benefit from collaborative actions.

Interinstitutional cooperation supports the development of the ESM's analytical capabilities and policies. Some relationships, for instance, expand access to data and information or complement the ESM's work. The ESM also consults with peers on best practices, reinforcing its lean structure and allowing staff to share knowledge and benefit from others' expertise, and it exchanges insights with government officials, financial market participants, and academia. Through these interactions, the ESM keeps abreast of economic analyses and developments. By participating in high-level meetings and conferences and by publishing content, the ESM contributes to policy debate.

Such cooperation differs in intensity and form given the varying factors behind engagement with each stakeholder, ranging from regular, informal bilateral dialogues to joint research projects and seminars. Some engagements are formalised through a signed agreement while others remain informal, arising organically as the policy environment and ESM institutional needs evolve. The ESM is adapting its collaboration framework in line with the new responsibilities foreseen in its enhanced mandate.

At the European level, the ESM nurtures a close relationship with the European Commission – which has intensified over time, largely due to the common work carried out to provide financial assistance. In April 2018, the European Commission and the ESM signed a Memorandum of Understanding that codified their existing working methods. Under the amended ESM Treaty, the ESM will have an enhanced role in the design, negotiation, and monitoring of financial assistance programmes in cooperation with the European Commission, deepening interactions between the two to be laid out in a Memorandum of Cooperation to be signed upon ratification of the amended ESM Treaty. The ESM has also established close ties with the ECB, as under the ESM Treaty the ECB is entrusted to perform specific tasks in liaison with the European Commission in the context of providing stability support. This has led to regular interaction at all levels, including discussions on topics of common interest such as euro area financial stability and the deepening of EMU. The ESM has also stepped up its collaboration with the Single Resolution Board (SRB) following the 2018 Eurogroup agreement on the creation of a backstop facility at the ESM for the SRF. The ESM and the

SRB worked jointly during 2021 on the methodology for assessing the SRB's repayment capacity. Such close cooperation is expected to continue to ensure full preparedness for any backstop activation.

At the international level, the IMF is one of the ESM's main multilateral partners. The two institutions have collaborated closely on programme design and reviews during the euro area debt crisis and continue to communicate regularly at managerial and technical levels to facilitate exchanges of ideas and provide inspiration on a range of policy matters. These interactions supplement other engagements with the IMF, such as the IMF Article IV consultation on euro area policies and intense interaction within the IMF annual and spring meetings that offer opportunities to discuss economic and financial developments in the euro area and the global economy more generally. In conjunction with peer regional rescue funds (Regional Financing Arrangements) across the globe, the ESM has also created a dialogue framework with the IMF to discuss crisis prevention and resolution issues and look for ways to improve cooperation with the IMF through annual policy meetings.

All these valuable partnerships help the ESM enhance its institutional capacity and contribute to safeguarding euro area financial stability. When the ESM takes on the new tasks of its broadened mandate, many existing interinstitutional ties will be fortified, and new cooperation opportunities sought. The Covid-19 pandemic has taught a valuable lesson on the importance of multilateralism, particularly at the regional level where close cooperation among European partners ensured an unprecedented, swift, and well-coordinated economic response to the pandemic shock. As we look cautiously toward the end of the health crisis, tackling priorities like the economic impact of climate change, ensuring inclusive and sustainable growth, and maintaining global stability in an uncertain geopolitical environment will require not only working hard but also working together.

Pandemic stimulates positive changes in ESM working methods

The ESM quickly adapted to new ways of working when Covid-19 erupted in early 2020, with most staff working from home and a small team in the office on an as-needed basis. The ESM's reliable technology infrastructure and systems, together with new digital channels of communication, made for a smooth transition. The ESM reinforced its cyber security systems and accelerated an existing project to implement a cloud-based collaboration platform, fostering secure connectivity and strengthening cooperation among staff and external stakeholders.

Throughout 2021, the pandemic continued to challenge the ESM's internal and external operations, but it also provided the ESM with opportunities to shift, adapt, and focus operations while ensuring fulfilment of its mandate.

The ESM's nine-member incident management team, comprised of senior staff and responsible for navigating the ESM through crises that threaten business continuity, continued its pivotal role of monitoring the evolving situation, advising management, providing staff with frequent updates, and shepherding the ESM through the pandemic.

Recognising the importance of social interaction and regular face-to-face contact, especially for colleagues experiencing isolation and increased anxiety, the ESM made it possible to work safely in the office and also improved the at-home experience. Steps taken included providing equipment such as headsets, ergonomic chairs, and computer screens to make working from home more comfortable; encouraging management to regularly check in with their teams; arranging virtual exercise sessions; and providing courses on maintaining emotional and physical well-being. At the same time, the ESM equipped offices with air purifiers, plexiglass separators between desks, and contactless bathroom facilities to considerably reduce the risk of infections at work and lessen the environmental impact.

ESM colleagues have proven resilient and flexible in the face of continuously shifting approaches to accommodate the ever-changing situation, adjusting office presence as viral variants subsided or emerged over the course of the year. The teamwork and dedication shown by those responsible for implementing new safety measures and rules for staff returning to the office were exceptional. According to feedback given, those returning to the office felt increasingly secure, with any initial apprehension dissipating, not least because all staff respected the rules for working together safely.

What began as a few weeks of working from home in an emergency has evolved into a catalyst for changing how we work, live, and interact. The imposed remote working has demonstrated that flexibility need not come at the expense of productivity, but rather can lead to increased productivity and efficiency. The ESM initiated a corporate project in September 2020 that analysed its pandemic experience to date and identified potential future ways of working, building upon the principles of agility, resilience, collaboration, and inclusion to define a provisional framework for hybrid working. The project will continue to monitor and assess the framework's business impact during a phased return to the office, with a testing period to identify the optimal operational model. The project outcome will ensure the ESM can not only withstand disruption, but also thrive in an ever-changing environment while maintaining a collaborative and close-knit culture.

The pandemic may have also permanently changed the ESM's interactions with its external stakeholders. The ESM's most frequent contact is with ESM Members, through the BoG and BoD as well as Eurogroup, Eurogroup Working Group, and Task Force on Coordinated Action meetings; peers in Regional Financing Arrangements and international financial institutions; and investors. Although the aims and content of these interactions differ, the new forms of collaboration and communication adopted during the pandemic are similar. Online meetings have largely replaced in-person interactions, and existing virtual formats have been adopted and adapted to strengthen professional relationships that once solely relied on travel and face-to-face contact.

The ESM's 2021 virtual Shareholders' Day was enriched with new virtual activities to supplement more traditional panel discussions. For example, the introduction of a virtual meetup tool gave participants the opportunity to interact one-on-one; ESM colleagues digitally presented posters showing the main conclusions and findings from their research publications, triggering dynamic discussions carried out in small breakout chat groups; and the ESM's Funding and Investor Relations team simulated an issuance transaction.

Alongside the EIB and the European Commission, the ESM organised its first hybrid event in June, a capital markets seminar, with speakers both in an on-site studio and attending virtually. The seminar attracted more than 1,000 participants, most of whom attended online.

The pandemic has offered new and valuable ways to collaborate, challenging the status quo. Overall, virtual interaction works well, notably when there is an established relationship between those meeting. Digital discussions are especially advantageous for the organisation of, and participation in, meetings spread across the globe. Reduced staff travel has also contributed to the ESM's ESG commitment to reduce its carbon footprint. Yet, virtual meetings and events cannot entirely replace the in-person experience, which helps build real bonds and understanding. The ESM will continue learning from this unprecedented change to optimise its hybrid ways of working together.

01 Economic developments

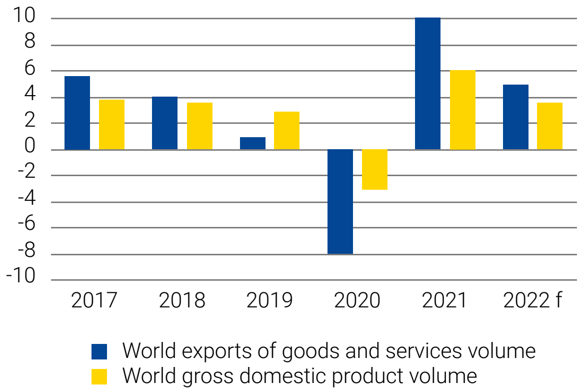
Macroeconomic and financial environment

Strong recovery with several challenges

Global economic activity recovered forcefully in 2021 from the unprecedented pandemic shock of the previous year. Progress in fighting the pandemic and continued concerted policy action at European and national levels contained the impact on labour market outcomes, mitigating risks of scarring and helping anchor the recovery despite further waves of Covid-19 infections. After muted growth in the first quarter, the euro area economy grew strongly in the second and third quarters before a new virus variant started to weigh on growth towards the end of the year. Appropriately supportive and mutually reinforcing economic policies have ensured effective macroeconomic stabilisation. In light of strong rises in global energy prices, together with a marked resurgence in Covid-19 cases, euro area member states extended the provision of safety nets for households and corporates – such as job retention schemes and public guarantees – the ECB's monetary policy remained accommodative, and the ESM's Pandemic Crisis Support credit line remained available, further helping reduce uncertainty. Looking ahead, the NGEU package, and in particular the Recovery and Resilience Facility within it, provides an opportunity to boost Europe's growth potential. Over the coming years, the effective implementation of reforms and investments under the Recovery and Resilience Facility will have a deep, positive impact on the functioning of the euro area economies.

Global economic activity continued to rebound strongly in 2021 following a sharp drop at the onset of the pandemic in spring 2020 (Figure 1). G20 countries' gross domestic product (GDP) grew by 6.1% to exceed its pre-pandemic level. The rollout of vaccinations and continued policy support partially decoupled economic activity from pandemic developments, and benefitted mobility and demand. While global trade increased by 10.1% in 2021 (Figure 1), protracted supply-side disruptions made it difficult to meet rising demand. Nevertheless, uncertainty dwindled as fiscal and monetary policy remained supportive.

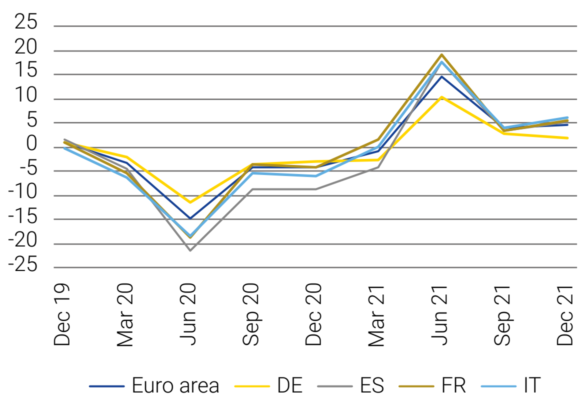
Figure 1
Global economic activity and exports of goods and services
(volume, year-on-year growth in %)



Note: f = forecast.

Source: IMF World Economic Outlook, April 2022

Figure 2
Real gross domestic product growth for selected countries
(year-on-year growth in %, quarterly data)



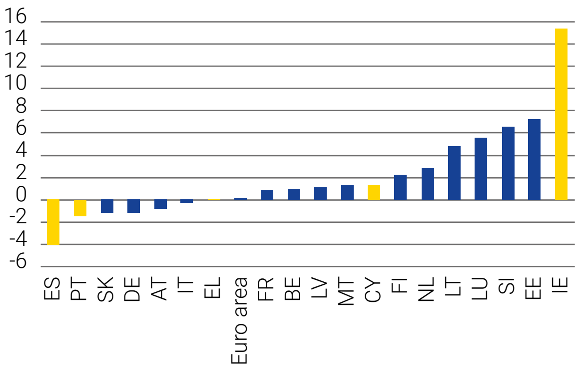
Source: Eurostat

Euro area GDP recovered in 2021, growing by 5.4% annually. A new surge of Covid-19 infections and containment measures muted the recovery in the first quarter (Figure 2). Growth strengthened in the second and third quarters as vaccination rates increased, economies reopened, uncertainty slightly moderated, and households' savings began to normalise, thereby boosting consumption. While demand expanded, industrial supply shortages ranging from specific inputs to broader sets of goods and raw materials impaired manufacturing and construction. In the fourth quarter, a new and highly transmissible virus variant pushed infections to unprecedented highs and hampered growth across the euro area (Figure 2). However, the variant induced less severe illness and fewer fatalities, prompting many governments to avoid strict lockdowns, limiting the impact on the economy.

Figure 3

Real gross domestic product in 2021

(Q4 2021 relative to Q4 2019 level, in %)



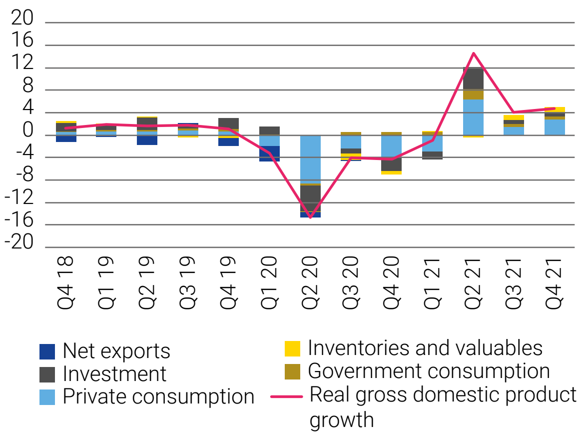
Notes: EFSF/ESM post-programme countries in yellow. Multinational corporations' activities may distort GDP figures in Ireland.

Source: Eurostat

Figure 4

Euro area contributions to real gross domestic product growth

(year-on-year growth in %, contributions in percentage points)



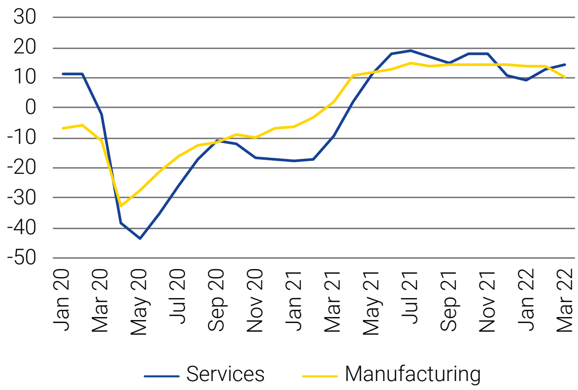
Source: Eurostat

The speed of the recovery varied across euro area countries and sectors in 2021 (Figures 3 and 4). The differences in growth performance are partially linked to the varying impact of the initial pandemic shock and the differing economic structures in place, such as dependence on manufacturing. Industries highly integrated into global value chains, for example the automotive sector, were hit particularly hard by the shortage of semiconductors, which contributed to supply-demand mismatches. Demand for services recovered (Figure 5), especially in the second and third quarters, but the tourism sector, crucial for several euro area member states, continued to perform significantly below its pre-crisis level.

Figure 5

Euro area services and manufacturing confidence

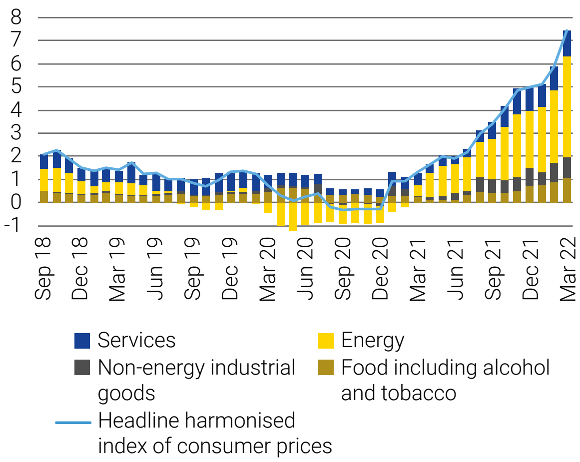
(% balance)



Source: Eurostat

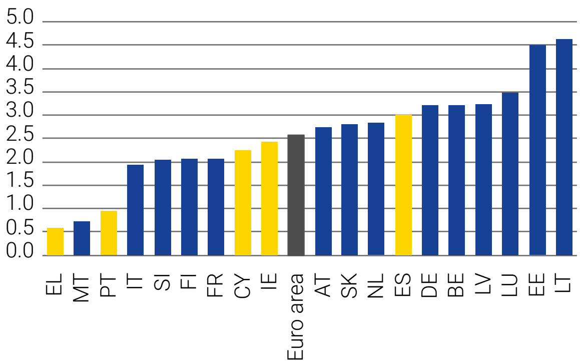
Euro area average inflation increased to 2.6% in 2021 from 0.3% in 2020 (Figures 6 and 7). Following months of slightly negative readings, monthly year-on-year headline inflation turned positive in January 2021 and trended upwards over the year, reaching 5% in December. Rising energy prices and strong base effects compounded with various initial temporary and administrative factors to trigger price pressures. Since mid-2021, euro area core inflation also gained traction and stood above 2.5% by year end. Inflationary pressures from wage negotiations remained contained overall, but rising producer prices created cost pressures for businesses. Market-based long-term inflation expectations increased in the second half of 2021, reaching close to 2% in the fourth quarter.

Figure 6
Euro area contributions to harmonised index of consumer price inflation rate
(year-on-year inflation in %, contribution in percentage points)



Source: Eurostat

Figure 7
Harmonised index of consumer price inflation rates in 2021
(in %)

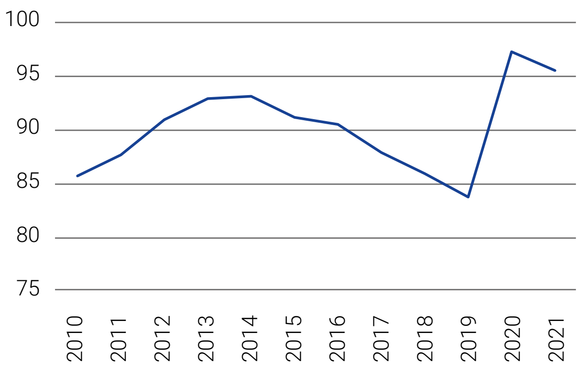


Note: EFSF/ESM post-programme countries in yellow.

Source: Eurostat

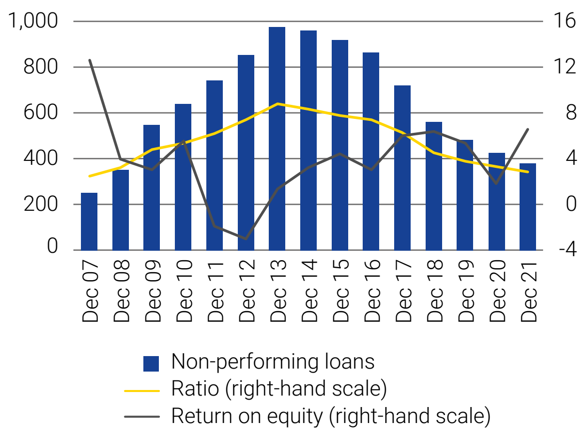
The extended activation of the Stability and Growth Pact's general escape clause provided euro area governments with the possibility for large amounts of fiscal support to respond to the pandemic and its negative economic impact. In 2021, unprecedented fiscal support gradually shifted towards the hardest hit economic sectors and vulnerable groups. Governments continued to provide financing to ensure healthcare systems functioned smoothly and to support employment and businesses. The pandemic fiscal response laid the foundations for a solid recovery but also led to an increase in euro area general government debt, peaking in 2020 at 97.2% of GDP. In 2021, the government debt-to-GDP ratio decreased to 95.6% due to strong economic growth and a slight decrease in the nominal debt in absolute terms (Figure 8).

Figure 8
Euro area government debt
(in % of GDP)



Source: Eurostat

Figure 9
Non-performing loans, non-performing loan ratio and return on equity in the euro area
(left-hand scale in € billion, right-hand scale in %)



Note: Single Supervisory Mechanism supervised banks.

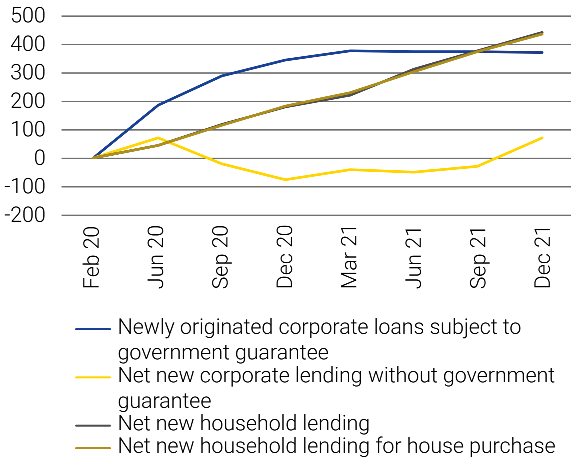
Sources: SNL, FitchConnect, ESM calculations

The successful rollout of the NGEU package and the Recovery and Resilience Facility within it has supported investments that facilitate green and digital transitions. By the end of the year, the facility had allowed the first disbursements to national governments, enhancing the euro area recovery. Increased investment promoting the twin transition underscores the benefits of the common crisis response.

The euro area financial sector remained resilient, thanks to concerted support measures as well as to generally good levels of capital and liquidity buffers held by banks at the start of the crisis. Initial fears of a significant increase in non-performing loans (NPLs) have not materialised; banks have effectively continued their risk reduction efforts, resulting in a 0.5 percentage point drop in the average NPL ratio during 2021. Banks' profitability started to recover after the slump of 2020, mostly on the back of reduced provisioning needs and favourable funding conditions. Return on equity reached 6.6% by end-2021, three and a half times higher than at end-2020 (Figure 9). Nevertheless, some traces of the pandemic crisis remain. Despite having sufficient lending capacity, banks' new lending to corporates, excluding that backed by public support, only began to recover in the last quarter of 2021, reflecting an improving economic outlook (Figure 10). During the last decade, capital markets somewhat compensated for missed lending activity by providing more funding to large corporates, including in the lower credit quality segment (Figure 11), a development that accelerated further during the pandemic crisis. Signs of increasing risks have emerged in real estate lending in some regions, with mortgage loans increasing by 5% year-on-year in 2021. In the longer term, low returns and cost inefficiencies continue to challenge the sector's competitiveness, while climate change and risks of a sudden repricing of assets could prompt instability in the financial sector. Policy initiatives such as banking union and capital markets union are designed to help the financial system move towards a more sustainable business model.

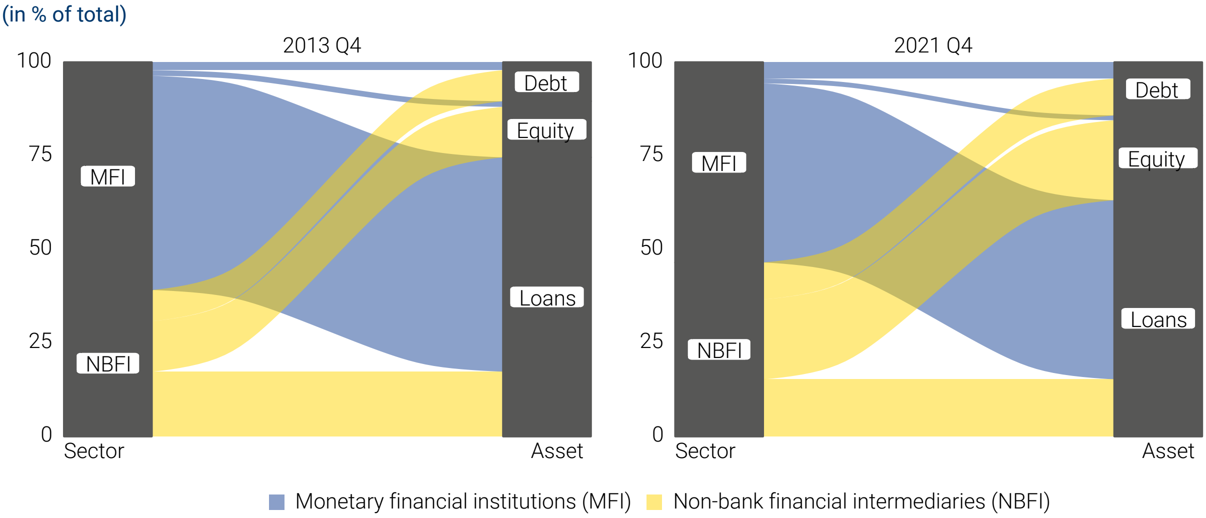
On global financial markets, reflation dominated throughout 2021. Market-based long-term inflation expectations rose in 2021 to 2.6% from 2% in the US and to 2% from 1.3% in the euro area. Yields on 10-year US Treasury bonds increased to 1.5% from 0.9%, and the GDP-weighted average euro area government bond yield turned positive, reaching 0.3%, up from -0.2%. While major central banks started scaling back asset purchases, financial markets are pricing in policy rate hikes in 2022.

Figure 10
Euro area banks' net new lending, cumulated flows
(in € billion, February 2020 = 0)



Sources: European Banking Authority Risk Dashboard, ECB, ESM calculations

Figure 11
Share of outstanding financing amounts extended to euro area firms by type of financial sector and asset
(in % of total)



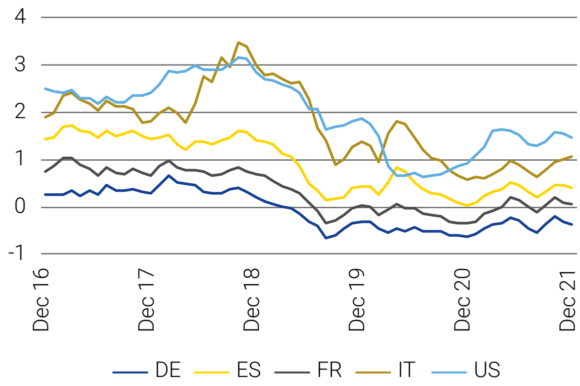
Source: ESM calculations based on ECB and Eurostat quarterly financial and non-financial sector accounts

Investors' risk appetite was resilient throughout 2021, equity markets continued to rally, and corporate and emerging market credit spreads remained broadly stable. Euro area sovereign bond yields were also largely unchanged, suggesting that market perceptions of country-specific risks remained contained (Figure 12).

Early 2022 developments

The euro area economy entered 2022 in a slightly weaker position than expected in the autumn of the previous year. In December 2021, a rise in Covid-19 cases triggered new mobility restrictions, supply chain disruptions, and further increases in energy prices, thereby generating faster and more broad-based inflation than anticipated. Elevated inflation is expected to persist for longer than projected last year.

Figure 12
Yields on 10-year government bonds issued by the US and selected euro area member states
(in %)



Source: ECB

The outbreak of the war in Ukraine in February 2022 caused enormous geopolitical uncertainty and led to significant revisions of previous growth projections. The European Commission published its preliminary fiscal guidance for 2023 in March 2022 but announced that it would update it if necessary – at the latest in May. The ultimate macroeconomic ramifications will depend on how the conflict unfolds and subsequent policy reactions.

Climate risks and the role of crisis prevention and resolution mechanisms

Climate change threatens our society and economies. Both climate change and responses to it pose various risks to financial stability. ESM Members have already responded at national, European, and international levels, including by signing the Paris Agreement – a binding international treaty on climate change. There are different channels through which climate-related risks might impact the financial system and financial stability.

Impact of climate-related risks on our economies

Climate-related risks to financial stability are those that arise directly from climate change or from efforts to mitigate and adapt to climate change. These can be either physical risks, such as extreme weather events or rising sea levels, or transition risks, such as large shifts in asset values, higher costs of doing business, or the socioeconomic challenges of the transition to a more sustainable economic model.

The possible impact of and exposure to physical risks varies across economies and sectors, and their respective banking and insurance sectors' loan books, portfolio holdings, or underwriting activities. Transition risks that arise from policies aimed at transitioning from a high- to a low-carbon economy and building a climate-resilient future could give rise to financial risks in multiple ways, which affect our economies, financial systems, and public finances that, in turn, raise financial stability issues. Transition risks affect financial institutions through credit risks, market risks, liquidity risks, operational risks, and reputational risks.

The transition towards a climate-neutral economy may depress investments in carbon-intensive sectors and their underlying assets, potentially leading to stranded assets burdening balance sheets in the public and private sectors. Countries with more emission-intensive industries are more exposed to transition risks and stranded assets.

At the macroeconomic level, climate change may impact the public sector balance sheet through growth potential and investment returns, which may affect a country's debt sustainability. Fiscal policy measures have an important role to play in fighting climate change. They will have to be widely used, also by increasing public investment, to incentivise the private sector to mitigate and adapt to the effects of climate change.

A collective effort for the common good

No country can fight climate change and limit global warming alone. Mitigation efforts serve to benefit all countries, making it a global public good. Addressing climate-related financial stability risks requires an unparalleled level of cross-country policy cooperation and coordination, whose success hinges on collective action.

The financial stability risks and the need for collective effort have direct implications for the role of crisis mechanisms, which are generally designed to detect vulnerabilities to prevent crises or to resolve crises that do occur. Such mechanisms can support the effectiveness of climate mitigation efforts. They are sovereign insurance mechanisms against the impact of climate change when a lender of last resort is needed.

Ensuring financial stability amid climate change

To help, crisis mechanisms should further integrate climate change considerations into their macrofinancial analyses and progress with the mapping of economic and financial exposures to climate risks. In addition to intensifying internal training on macrofinancial climate analysis, crisis mechanisms can support national efforts to expand or establish climate best practices by providing training and technical assistance. More specifically, they can exchange information, participate in international forums, and cooperate with partner and peer institutions across the globe on climate risks.

By improving data, analyses, and risk monitoring, crisis mechanisms can test the fitness of their available instruments and address ESG needs and climate change-related risks – adjusting their toolkits to close remaining gaps.

Monitoring and surveillance activities that include climate change considerations will help crisis mechanisms to prevent crises from materialising and inform policymakers on the externalities of climate change. With early warnings, markets are better informed in their pricing and a sudden sizeable repricing of climate-related risks or a reversal of financing flows becomes less likely.

The role of crisis mechanisms is to identify, pool, and insure against acute risks to governments that they cannot resolve themselves. Building sovereign resilience to climate change is key to mitigating inherent risks that touch every aspect of the global economy and to ensuring a better future for our societies.

The ESM has integrated ESG considerations into its market operations and internal processes and is deepening its analyses of the implications of climate change for financial stability. On the following pages, you will find comments from peer institutions on how the ESM can play a role in the shared endeavour of creating a more resilient and sustainable future.

Thoughts from institutional peers

How relevant is the ESM's commitment to help allocate funds for social needs in the euro area?

"By having designed a social bond framework, aligned with the ICMA Principles, to finance the Pandemic Crisis Support tool, the ESM has demonstrated vital public-sector leadership in helping to build this extremely important but still considerably underutilised area of ESG-related bonds globally."

Bryan Pascoe
Chief Executive, International Capital Market Association (ICMA)

How can regional institutions support members in mitigating the socioeconomic impacts of climate change?

"Development policy choices disproportionately influence the ability of countries to adapt to climate change. Regional institutions can help mitigate the negative implications of climate change by supporting countries to systematically assess climate risks and vulnerabilities, develop local capacities, integrate appropriate resilience measures into development policies, and allocate resources to increase resilience to climate change."

Abdulrahman A. Al Hamidy
Director General Chairman of the Board, Arab Monetary Fund (AMF)

How can the ESM contribute to the work of the NGFS?

"We welcome the ESM's work on the implications of climate change on financial stability, and we look forward to working together to strengthen the resilience of the financial system to climate risks. ESM's regional reach and strong commitment will support the NGFS' efforts to accelerate the greening of the financial system."

Ravi Menon
Chair of the Network of Central Banks and Supervisors for Greening the Financial System (NGFS)

What role do European and international institutions play in the fight against climate change?

"Climate change poses major risks to the global financial system. To preserve economic stability and seize the new opportunities offered by the green transformation of our economies, the financial community must work closely together. The EIB is delighted to cooperate with ESM and partners from around the world to unlock sustainable finance at scale."

Werner Hoyer
President, European Investment Bank (EIB)

Why is it essential for international financial institutions to consider climate-related risks in economic surveillance?

"Climate change is a critical policy challenge that already imposes large economic and social costs on many economies. In the period ahead, it is bound to affect macroeconomic and financial stability through numerous transmission mechanisms, including fiscal positions, asset prices, trade flows, and real interest and exchange rates—so engagement on this issue is vital."

Gita Gopinath
First Deputy Managing Director, International Monetary Fund (IMF)

How can regional institutions support economies in responding to climate-related risks?

"Climate change is a global challenge that requires us to join forces to be part of the global solution. Regional institutions have the responsibility to identify opportunities for our members to facilitate their mitigation of and adaptation to climate change, and transition towards greener economies. By engaging in regular dialogue and sharing of expertise, we can strengthen regional resilience to disasters and secure inclusive 'climate prosperity' for all."

Toshinori Doi
Director, ASEAN+3 Macroeconomic Research Office (AMRO)

How can the European Commission and the ESM cooperate on factoring climate-related risks into economic analysis?

"Climate change has significant economic and fiscal implications linked not only to physical risks, like natural disasters, but also to those stemming from mitigation and adaptation policies aimed at supporting the transition to climate-neutral economies. The European Commission stands ready to collaborate with the ESM in supporting member states in the event that these risks were to affect financial stability."

Paolo Gentiloni
Commissioner for Economy, European Commission

Why is it important to pay due attention to climate change from a financial stability perspective?

"The physical and transitional risks of the climate and environmental crises are not hypothetical, but a reality. Analysis confirms that the consequences constitute a material risk to financial stability. European institutions – including the ESM and the ECB – take action in recognition that this is necessary to deliver on their mandate."

Frank Elderson
Member of the Executive Board, European Central Bank (ECB)

What impact can the ESM have as a signatory of the UN Principles for Responsible Investment?

"As a PRI signatory, the ESM has prioritised ESG integration across the organisation's investment activities, designing a responsible investment framework to measure and monitor investments. By committing to ESG integration and promoting sustainable investment practices, the ESM sets an important example for others to foster greater financial stability."

David Atkin
Chief Executive Officer, United Nations Principles for Responsible Investment (UN PRI)

Former programmes

Ireland

The Irish economy grew strongly in 2021 as it recovered from the pandemic, aided by strong exports and a rebound in domestic demand. Fiscal policy remained supportive, and growth helped reduce the deficit-to-GDP ratio. Low borrowing costs and fiscal overperformance allowed Ireland to maintain a fairly favourable fiscal position and sizeable year-end cash buffers. Irish banks' financial positions remained sound, with profitability improving.

Real GDP growth accelerated to 13.5% in 2021 due to the recovery of private consumption from pandemic-induced lockdowns and strong export growth. A measure for domestic economic activity corrected for the influence of multinational firms increased by 6.5%, supporting the recovery of labour markets. The Covid-adjusted unemployment rate[1] declined to 7.4% by end-2021, down from its April 2020 peak of 31.5%, but remains above the longer-term average rate of around 5%. Extensive support measures helped prevent bankruptcies. The recovery saw the harmonised index of consumer prices inflation rate accelerate to 5.7% in December 2021, due to rising energy prices and global supply chain disruptions. Exports performed robustly thanks to the activities of resident multinational companies. New Brexit-related trade frictions were mitigated by pre-Brexit stockpiling, policy support, and the shift of trade routes to direct shipping to and from the European continent.

The budget deficit was lower than expected, at 1.9% of GDP, due to stronger tax revenue and underspending. The domestic economy's rapid recovery aided the upturn in income tax receipts and a strong rebound in VAT. Strong export activity swelled corporate tax revenues beyond expectations, despite the potential instability of a significant portion stemming from multinational companies. Public expenditure turned out lower than expected due to an overall decline in pandemic-related claims as well as lockdown-induced closures of construction. Strong GDP growth reduced gross debt to 56% of GDP from 58.4% in 2020, despite a further increase in the absolute level of debt in 2021. However, the debt level remains high under alternative scaling metrics that isolate GDP distortions caused by the highly mobile activities of multinational companies.

Low borrowing costs allowed Ireland's National Treasury Management Agency to reduce the average cost of government debt, with the cost of long-term bond issuances falling slightly to 0.17%. With issuances of €18.5 billion in 2021 (down from €24 billion in 2020), and a lower-than-expected budget deficit, Ireland ended the year with a sizeable cash buffer. Credit ratings of AA or A with stable or positive outlooks and accommodative monetary policy enabled favourable market access conditions. The return of the 10-year Irish bond yields to positive territory by end-2021 was in line with euro area interest rate developments.

The impact of the pandemic on the financial position of the retail banking sector started to dissipate in 2021, reflecting the improved economic outlook. Irish retail banks' capital and liquidity positions remained strong and well above regulatory minimums. Asset quality improved during 2021, though risks may arise in some portfolios as policy support fades. Bank profitability returned to pre-pandemic levels, although vulnerabilities remain due to the strong reliance on net interest income and a high cost base. The sector continued to benefit from an ample deposit base.

Under its Early Warning System, the ESM monitors risks to its loan service payments. The Irish economy proved resilient, but uncertainty persists. Main risks relate to a weaker external environment and rising inflation, further aggravated by the Ukraine crisis, albeit that Ireland's direct trade and investment exposure to the belligerent parties remains small. Other risks comprise a limited delivery capacity for public investments and potential issues affecting trade with Ireland if the Trade and Cooperation Agreement between the UK and the EU, including the Ireland/Northern Ireland Protocol, is not fully implemented. Changes to the international corporate tax regime warrant fiscal prudence.

[1] The Covid-19 adjusted unemployment rate classifies all claimants of the Pandemic Unemployment Payment, a job retention scheme, as unemployed.

Greece

The Greek economy recovered vigorously from the pandemic, driven by strong domestic demand and tourism. The budget deficit accommodated a large package of fiscal support to households and firms. Market conditions remained favourable, supported by the ECB's accommodative monetary policy stance and the NGEU recovery plan. Meanwhile, banks strengthened their balance sheets.

Greece's economic activity grew by 8.3% in 2021, essentially recovering the output losses recorded in the previous year due to the impact of Covid-19. Households and firms used accumulated savings to boost consumption and investment, and tourism surged. The government's large fiscal support package propped up incomes and employment throughout the year.

The primary balance improved significantly to -5.5% of GDP in 2021, from -8% the year before. The government provided extensive support to households, employees, and firms, with one of the largest discretionary fiscal packages in the euro area. Thanks to rapid growth, the debt-to-GDP ratio fell to 193.3% of GDP from 206.3%.

Greece's sovereign financing conditions remained favourable throughout the year. It over-executed its 2021 funding plan, raising €14 billion in market funding, and maintained a cash buffer that more than covered gross financing needs over the coming 12 months. Amid strong investor demand, sovereign spreads fell to their lowest levels since the sovereign debt crisis, before widening moderately later in the year. In December, the ECB announced it would discontinue net purchases under the pandemic emergency purchase programme from March 2022, and only reinvest redemptions. This also concerns Greek sovereign bonds. However, the ECB also announced reinvestments could include purchasing Greek bonds beyond rollovers of redemptions to avoid interrupting purchases in that jurisdiction that could impair the transmission of monetary policy to the Greek economy while it recovers from the fallout of the pandemic.

Bank solvency indicators remained adequate amid a sharp decline in banks' NPLs. Two systemically important institutions raised new capital from private investors. NPL sales and securitisations are supported by the government-backed Hercules asset protection scheme and strong investor demand. As a result, banks more than halved their aggregate NPL ratio to 12.8% by the end of 2021. Yet the overhang of private debt remains, underscoring the need for an efficient enforcement framework. Bank lending activity was cautious, failing to mirror the vigorous rebound in the rest of the economy. Private-sector credit to non-financial corporates expanded by 3.7% while credit to households declined by 2.4% year-on-year in December 2021.

Greece further progressed in implementing its reform commitments and, as a result, received the fifth and sixth tranches of semi-annual, policy-contingent debt relief measures totalling €1.5 billion. Favourable ESM and EFSF lending terms also provided budget savings estimated at about €8 billion in 2021.[2]

Greece reached several important milestones in its comprehensive reform agenda: the implementation of a new insolvency framework; further progress in privatisation, notably of land at Athens' former airport; and the adoption of an ambitious strategic plan to strengthen governance in state-owned enterprises and improve financial discipline. However, some reform efforts encountered delays and setbacks, such as the plan to reduce non-pension arrears to zero in 2021.

Under its Early Warning System, the ESM monitors risks to Greece's repayment capacity. In the short term, Greece enjoys a comfortable liquidity position, stable market access, low financing needs that reflect a long average maturity, and significant financial support from NGEU. But over the long term, Greece remains vulnerable due to macroeconomic imbalances, particularly its very high public debt, as well as to a persistent investment gap, low productivity, and high NPLs. To remedy these weaknesses, Greece has embarked on an ambitious journey to modernise its economy. The reform priorities include addressing long-standing weaknesses in infrastructure; education and skills; and public administration, including the justice system. The war in Ukraine casts shadows over the economic outlook for Greece. The magnitude of the impact remains to be seen, but Greece may be affected given its dependence on tourism and on imports of Russian oil and gas.

[2] The ESM estimates the budget savings by comparing Greece's borrowing rates on ESM/EFSF loans with its market interest rates at the time of the disbursement of the ESM/EFSF loans. Specifically, these estimates reflect the spread between Greece's seven-year market rates at the time of disbursements and the actual ESM/EFSF interest cost in 2021.

Spain

After the sharp recession of 2020, Spain returned to economic growth in 2021. A successful Covid-19 vaccination strategy helped mitigate the health and economic impact of the pandemic. Prompt policy support to firms and households dampened the pandemic shock but affected public finances. Nevertheless, the Spanish Treasury benefitted from favourable market access conditions, supported by monetary policy and investors' confidence. Spanish banks' profitability and capital ratios have improved since the pandemic, thanks to policy support measures as well as to balance sheet enhancements over the last decade.

The Spanish economy rebounded in 2021 after an unprecedented contraction of 10.8% in 2020. Real GDP grew by around 5%, mainly powered by domestic demand. High vaccination rates and declining hospitalisation rates drove national authorities to ease restrictions further, supporting economic activity. External demand also reinforced growth, although the tourism sector has yet to fully recover. The labour market recovery was notable, driven mainly by effective policy measures, reaching pre-pandemic levels. The unemployment rate declined to 13% in December 2021 from 16.3% for the same period in 2020, and the employment rate rose by more than 2.5% in 2021. Annual inflation reached 3% due to rising energy prices and supply chain disruptions.

The budget deficit narrowed to 6.9% of GDP in 2021 from 10.3% in 2020, following the economic recovery and gradual withdrawal of discretionary measures to combat the effects of the pandemic, though it remains high. The debt ratio also diminished to slightly above 118% of GDP in 2021 from about 120% in 2020. NGEU funds provide a good opportunity to boost investments and structural reforms that aid potential growth and improve Spain's fiscal position. The government has made progress on reforms associated with the Recovery and Resilience Facility and has been the first country to receive a disbursement associated with the satisfactory fulfilment of the milestones of the first instalment, which together with the pre-financing, adds up to around 2% of GDP in grants in 2021.

Spain retained very favourable financing conditions in 2021, with the average cost of newly issued and outstanding debt reaching historic lows of -0.04% and 1.64% respectively. Spain's 10-year yield dropped to around 0.4% on average in 2021 from its March 2020 peak of 1.2%. Average maturity lengthened to eight years, which will dampen the impact of any future increase in market interest rates. The main credit rating agencies maintained Spain's ratings. S&P assigned Spain a negative outlook in late 2020 but returned it to stable in March 2022, based on the soundness of its long-term economic prospects. Economic growth combined with credible medium-term fiscal plans will be key to maintaining investor confidence.

Importantly, the Spanish banking sector weathered the pandemic well. Profitability rebounded in the first three quarters of 2021, and capitalisation improved. NPL ratios fell further during 2021, though the pace slowed as public support measures started to expire. Credit growth was markedly varied across sectors, with a surge in new credit to households while credit to non-financial corporations dwindled. Sareb, the asset management company for proceeds from bank restructuring, was fully incorporated into Spain's government accounts following a Eurostat decision, explaining the public debt increase of up to three percentage points in 2020. Furthermore, the Spanish government has acquired a majority share in Sareb from the private sector.

Under its Early Warning System, the ESM monitors risks to its loan service payments. The Spanish Treasury retains the capacity to service its debt, including loan service payments to the ESM over 2022. Spain's economic activity is projected to continue strengthening in 2022, despite downside risks to the outlook. The reforms and investment funded by NGEU are expected to raise growth potential and further enhance Spain's fiscal sustainability and capacity to respond to future shocks, subject to the successful implementation of the recovery plan. The pension system and tax reforms envisaged in the recovery plan are also key to addressing medium-term fiscal challenges. Despite Spain's limited direct trade exposure to Russia, the economic and financial impact of the conflict in Ukraine may still affect the country through higher energy prices and a slowdown in key trading partners.

Cyprus

The Cypriot economy staged a strong recovery in 2021 from the impact of Covid-19, slightly surpassing the euro area average. This rebound helped reduce the budget deficit, even while pandemic-related fiscal support continued to be offered to households and businesses. Cyprus enjoyed overall favourable financing conditions backed by an accommodative monetary policy stance and began to reduce its precautionary liquidity buffer towards pre-pandemic levels. Banks' NPLs shrank and profitability recovered, but asset quality concerns remain until the full impact of the pandemic is known. Completing structural reforms in several areas would boost the country's growth potential.

Cyprus' GDP swelled in 2021 as the pandemic receded and vaccination numbers rose. Real economic activity rebounded by about 5.5% in 2021, following a 5% drop in 2020, largely driven by domestic demand and supported by fiscal measures. Cyprus' 2021 annual growth slightly exceeded the euro area average, partly due to fewer containment measures and less severe supply-side shortages. External demand, especially tourism, remained significantly below pre-pandemic levels. However, the labour market strengthened, showing an unemployment rate of 6.6% in December 2021 – comparable to the pre-pandemic level.

The fiscal deficit also remained below the euro area average, with higher revenues stemming from the economic recovery offsetting larger pandemic support measures. The primary balance turned slightly positive and stood at 0.1% of GDP in 2021 compared to a deficit of 3.7% in 2020, while support measures reached about 3.1% of GDP in 2021 from 3.6% in 2020. Contingent liabilities from government guarantees for the private and public sectors were contained. The public debt ratio fell to 103.6% of GDP in 2021 from 2020's 115%, largely thanks to a gradual reduction of the large precautionary cash buffer, as well as to the recovery. Cyprus' credit ratings from DBRS, S&P, and Moody's improved in 2021, triggered by the favourable growth outlook supported by European funds and strong fiscal performance. All main rating agencies, except for Moody's, continued to assign investment grade to Cyprus. However, high private and public debt levels constrained the country's creditworthiness.

Cyprus enjoyed an overall positive market perception in 2021. New sovereign debt issuances recorded favourable outcomes. Yields remained relatively low with spreads widening towards year end, akin to the evolution seen in the rest of the euro area. The ECB's monetary policy measures continued to support advantageous financing conditions and, in September, Cyprus received a first disbursement of €157 million under the NGEU programme.

The banking sector was resilient and NPLs declined by almost three percentage points in 2021 to reach an overall reduction of 85% from their 2015 peak, thanks to government legislative initiatives and reforms and banks' continued efforts to progress with risk reduction. On the back of the improving macroeconomic outlook and favourable funding conditions, banks' profitability began to recover. Nevertheless, uncertainties remain due to pandemic-related risks. The proportion of loans with increased credit risk remains elevated and the private sector's high indebtedness constrains banks' ability to provide new loans. Policy initiatives, such as the government guarantee scheme and the implementation of reforms incorporated in the recovery and resilience plan, could help address these issues.

Under its Early Warning System, the ESM monitors risks to repayment capacity. The economic outlook for Cyprus improved throughout 2021, with the pandemic remaining the main downside risk. While recent waves of infection have done less economic damage, Covid-19 still has the potential to impair activity, particularly in tourism. Over the medium term, elevated household and corporate debt make the economy vulnerable, and risks in the financial sector could hobble banks' ability to provide sufficient lending. Completing reforms of local governments, the justice system, and public administration would enhance Cyprus' growth potential, but absorption and implementation risks remain. The economic consequences of the war in Ukraine are not yet fully visible. Sanctions imposed on Russia could have sizeable repercussions for the Cypriot economy, especially in the tourism sector. In the financial sector, immediate risks have been mitigated and resolved as direct exposures to Russia were largely concentrated in one entity, while Cypriot banks on average have a low exposure to the Russian economy.

Portugal

In 2021, private consumption and investment supported Portugal's partial recovery from the economic downturn induced by the Covid-19 pandemic. A rebound in fiscal revenue led to a reduction in the primary deficit. Government bond yields increased on the back of rising euro area inflation expectations, but market access conditions remained favourable mainly thanks to accommodative monetary policy. Portuguese banks' profitability has recovered and NPLs have declined further.

Real GDP grew by 4.9% in 2021 after declining by 8.4% in 2020, mainly driven by the upturn in domestic demand. Given the asymmetric impact of the Covid-19 pandemic, real GDP did not, however, fully recover from the shock, remaining 1.4% below its pre-pandemic level at year end. The labour market improved, with overall employment more than undoing pandemic-related job losses and the unemployment rate stabilising at a low level. As an important step to solidifying the recovery, the European Council approved Portugal's recovery and resilience plan in mid-July 2021, with a total envelope of €16.6 billion (8.2% of GDP) for 2021–2026.

The 2021 primary deficit narrowed to 0.4% of GDP from 2.9% of GDP in 2020, due to increased revenues fuelled by the economic recovery. While fiscal support required to address the negative impacts of the Covid-19 pandemic continued to weigh on the budget, the government maintained its commitment to strengthen fiscal consolidation, as public debt shrank slightly to 127.4% of GDP from 135.2% the previous year.

Portugal's market access remained stable. The Portuguese Treasury and Debt Management Agency's gross bond (Portuguese Government Bond) issuance reached €19.4 billion, which translated into a net issuance of €6.8 billion. The ECB's accommodative monetary policy also helped ensure supportive financial conditions.

Portugal enjoys an investment grade rating from major credit rating agencies. Fitch and S&P reverted to stable outlooks from positive in 2020. Moody's, however, upgraded Portugal to Baa2 in September 2021, citing the normalisation of employment levels and a robust economic rebound. DBRS maintained the country's rating 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 helped stimulate a more resilient banking system, while capital and liquidity ratios improved, increasing capacity to support a real economy recovery. Banking sector profitability also improved considerably in 2021. Progress towards decreasing the stock of NPLs has continued, and most loans already out of moratoria schemes before the end of the third quarter were performing normally. Public guarantee schemes played a lesser role in supporting loan growth in 2021 compared to 2020.

Under its Early Warning System, the ESM monitors risks to its loan service payments. Economic activity is projected to strengthen in 2022, despite downside risks to the outlook, and the reforms and investment funded by NGEU could further enhance Portugal's capacity to respond to future shocks. Portugal's high public debt burden remains an important source of vulnerability. However, uncertainty has significantly increased recently. Despite limited direct trade and financial links with Russia and Ukraine, and a moderate direct gas import share from Russia, Portugal's high external energy dependency and consequent rise in domestic energy prices leave the country vulnerable to the geopolitical environment.

02 ESM activities

Asset and Liability Management and Financial Structuring

Asset and Liability Management (ALM) and Financial Structuring conducts analyses and tests to ensure readiness of the Pandemic Crisis Support credit line.

The team prepares all operational processes for any possible future deployment of the SRF backstop, including a thorough dry-run exercise.

The team seeks efficiency gains through the automation of key operational processes.

The ALM and Financial Structuring division measures, monitors, and manages liquidity, currency, and interest rate mismatches between assets and liabilities that may arise from the execution of the ESM and EFSF mandates. Financial structuring, interest rate modelling, simulation, and scenario analysis covering all balance sheet risks are other major parts of the team's work.

The division contributed to maintaining the Pandemic Crisis Support credit line's readiness for use by conducting detailed analyses and testing of the facility.

The team also contributed to preparations for the implementation of the ESM backstop for the SRF by preparing the operational processes required for a possible future deployment, testing their implementation with a thorough dry-run exercise, and by highlighting all balance sheet risks associated with the provision of liquidity in the banking crisis resolution framework.

Beyond this work, the 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 continued to work on debt portfolio analysis to forecast variability of debt interest costs. Additionally, the team continuously sought ways to enhance efficiency in data management through further automation of operational processes such as simulations, analyses, and reporting. The team worked with the Funding and Investor Relations division to create synergies in managing liquidity.

Lending

ESM collaborates with the SRB to develop frameworks to ensure timely repayments and fiscal neutrality under the common backstop facility foreseen in the amended treaty.

Greece concludes its second early repayment of IMF loans after gaining a waiver from the ESM and the EFSF.

As part of continued preparations for the backstop for the SRF, the Lending division contributed to joint efforts to adapt the ESM's Early Warning System, the tool for ensuring timely repayments, to monitor loans provided under the common backstop foreseen in the amended treaty. The team also worked with colleagues from the SRB to develop a framework for assessing and structuring loans, to ensure fiscal neutrality over the life of any loan drawn under the backstop facility.

In February 2021, Greece requested the ESM and the EFSF approve an early repayment of part of its outstanding loans to the IMF, amounting to approximately €3.3 billion, without proportionally repaying the ESM and the EFSF. This was Greece's second early repayment to the IMF. Consequently, the ESM and the EFSF, considering the benefits of the prepayment to Greece's debt management operations, approved a waiver of the proportional repayment provisions due when parallel official-sector financing is repaid ahead of schedule. On 15 June 2021, Greece also repaid €27.2 million early to the ESM in connection with the dividend of the Hellenic Corporation of Assets and Participations.

The Lending team continued its management of the existing loan portfolio, with a total outstanding amount of €264.5 billion at the end of 2021.

Funding and Investor Relations

EFSF kicks off 2021 with record €70 billion order book on dual bond transaction.

ESM/EFSF issue €24.5 billion in bonds, with regular new lines and taps on existing bonds.

ESM celebrates 10 years of bond issuance at Luxembourg Stock Exchange.

ESM issues €46.6 billion in bills, despite low yields.

ESM moves to new derivatives programme.

ESM US-dollar transaction priced with single-digit spread garners record allocation in the Americas.

ESM launches Funding and Investor Relations LinkedIn page.

Medium-sized bonds across the curve maintain market presence

The ESM reached its 2021 combined funding target of €24.5 billion, with a split of €8 billion for ESM and €16.5 billion for EFSF (Figure 13).

For 2021, the ESM focused its funding strategy on issuing medium-sized benchmark transactions, of €2 to €3 billion across a range of maturities, as well as tapping outstanding lines. This approach allows the ESM to be regularly present in the market and keep investor interest, maintaining access to cheap funding should it need to rapidly raise funds to provide emergency financial assistance – critical for a last resort mechanism like the ESM.

In March 2021, the EFSF and its successor the ESM celebrated 10 years of bond issuance and listings at the Luxembourg Stock Exchange with a bell ceremony. The virtual event gathered investors, bankers, lawyers, and media and offered an opportunity to reflect upon the EFSF's first bond issuance in 2011, and to look towards the ESM's future.

The EFSF enjoyed a new record €70-billion order book on a dual-tranche transaction in January, evidence of continued strong demand for issuances during 2021 despite lower coupons and negative yields.

In September, the ESM marked another record, this time on a US dollar transaction that priced for the first time with a negative spread versus Libor and with a single-digit spread to US Treasury bonds. Despite such tight pricing, the demand had a record allocation of 39% in the Americas versus 29% across all the USD bonds previously issued. It also attracted 64% central bank investors versus an average of 55%.

ESM issues €46.6 billion in bills

The ESM bill programme continued to attract investors in 2021, providing a useful tool for additional liquidity and flexibility.

The ESM issued a total of €46.6 billion in bills over 2021, split between an €18 billion 3-month bill, a €16.5 billion 6-month bill, and a €12.1 billion 12-month bill. The highest average yield was -0.60% for the 12-month bill issued on 9 March, and lowest average yield was -0.85% for the last 3-month bill issued for the year.

ESM switches derivative exposure rate

The ESM replaced the interest rate benchmark used in derivative contracts, the Euro Overnight Index Average (EONIA) rate used until 2 January 2022, with the euro short-term rate (€STR). When EONIA was declared non-compliant for benchmark reference, all derivatives contracts needed a replacement solution. The switch changes the exposure of collateralised derivatives to the new rate, which reflects the wholesale euro unsecured overnight borrowing costs of euro area banks.

The derivatives and market intelligence team contributed to the project through pricing and execution of these benchmark switches. This comprised a multi-billion sized derivative portfolio with various counterparties, which were all executed successfully within the timeline for the benchmark rate switch.

Investor relations adapt and blossom over 2021

Given the pandemic, investor relations took place in either virtual or hybrid format. The Funding and Investor Relations team also enhanced their online presence by launching a dedicated LinkedIn page in September, as part of efforts to maintain communication and cultivate relationships with investors in an increasingly digital-contact focused world.

The ESM organised a total of 16 hybrid roadshows and conferences, 16 high-level meetings, and more than 30 one-on-one calls with investors.

The virtual attendance of nearly 1,000 investors from some 30 countries marked the success of the ESM's second annual capital markets seminar, co-organised with the European Commission and the EIB in June.

As the pandemic and associated risks abated in the autumn, the Investor Relations team organised several trips to visit investors in person in Paris, Frankfurt, Milan, Amsterdam, and New York.

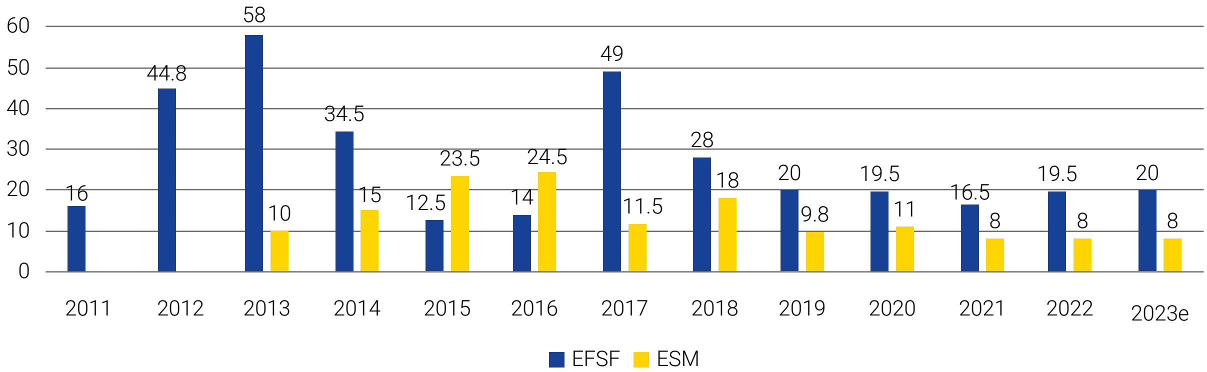
The ESM investor base grew by 34 new investors this year, now totalling over 1,700 investors globally. The breakdown remains well diversified geographically and by investor type (Figures 14 and 15).

Over the year, the team observed that Europe remained well perceived by the investor community, which was reflected in the positive reception of ESM's bond offerings. The strength of the euro as an international currency was a recurrent topic in investor forums.

Funding outlook 2022

The combined funding target for the EFSF and the ESM for 2022 is €27.5 billion, comprising €19.5 billion for the EFSF and €8 billion for the ESM.

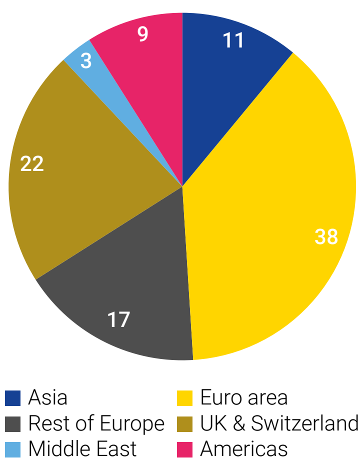
Figure 13
EFSF/ESM Bond issuance
(in € billion)



Note: e = estimate.

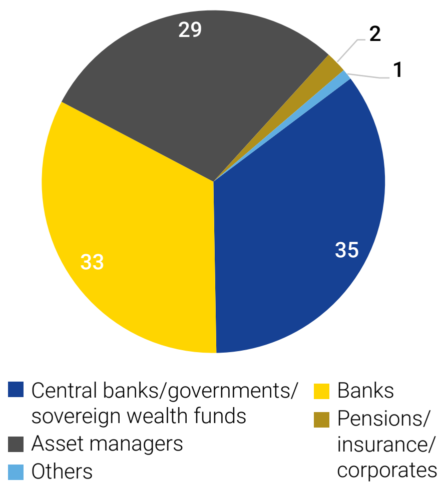
Source: ESM

Figure 14
Investor participation in ESM syndicated bonds in 2021, by geography
(in %)



Source: ESM

Figure 15
Investor participation in ESM syndicated bonds in 2021, by investor type
(in %)



Source: ESM

Table 1
ESM ratings

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

Note: Scope and DBRS Morningstar ratings are unsolicited.

Sources: The rating agencies named, compiled by the ESM

ESM’s funding strategy evolves with the times

The ESM is continuously adapting and exploring new working methods to best serve its shareholders, investors, and the debt capital market as a whole. To this end, the ESM funding strategy evolves with changing debt capital markets and in line with the ESM’s upcoming broadened mandate.

The year 2021 marked the 10th anniversary of the first EFSF bonds, with the ESM following in 2013. Established to raise funds for euro area countries that lost access to debt financing, the EFSF and ESM began to raise funds amidst an environment where trust in Europe was low and debt had to be issued in large quantities and with great speed. What began with a simple back-to-back funding strategy, where the bonds matched the loans disbursed, later developed into a diversified funding strategy where financing was pooled and then disbursed.

From late 2012, an issuance calendar, newsletter, and regular investor calls and roadshows provided investors with transparency and certainty. These actions also helped rebuild trust in Europe by offering the certainty of a reliable and predictable partner. A bill programme was added to provide extra liquidity and offer investors different instruments to invest in. In 2016 the ESM added privately placed N-bonds (Namensschuldverschreibungen), and in 2017 introduced a US dollar bond programme to further diversify the investor base. In 2020, the bill programme was extended with the addition of a new 12-month bill.

Circumstances have changed markedly since the inception of the rescue funds. Since the conclusion of the last ESM assistance programme in 2018, funding has been undertaken solely to finance the rollover of existing debt. The EFSF and ESM will continue to issue around €20–€25 billion annually in rollover debt for the foreseeable future.

With confidence in Europe and the euro greatly restored since the height of the sovereign debt crisis, and beneficiary Member States enjoying favourable market access, the ESM announced in December 2021 that it would cease advance publication of potential windows of bond issuance to pursue a nimbler, more opportunistic strategy.

The upcoming change in the ESM mandate, broadening the institution’s mission, also demands such agility in the funding approach. Once the new treaty enters into force, the ESM will provide the backstop for the SRF, should additional emergency funding be required for bank resolution. Bank resolutions can happen over a weekend, putting a premium on agile fundraising. However, unlike a country assistance programme, a bank does not necessarily need a cash transfer but, rather, to strengthen its balance sheet through recapitalisation. The ESM is prepared for this as well, with a disbursement-in-kind strategy that allows it to issue bonds that can be lent directly to the beneficiary, without selling them to end-investors.

European debt capital markets also evolve, and issuers' funding programmes fluctuate according to their financing requirements. These have been particularly pronounced during the Covid-19 pandemic, where issuers, such as France's social debt amortisation fund and the EU's newly formed Support to mitigate Unemployment Risks in an Emergency programme and NGEU, have increased funding while those like the ESM have scaled back. Tighter spreads across euro area government bonds have encouraged national issuance while NGEU grants offer an attractive alternative for governments to loans from EU supranationals.

The ESM funding team, however, remains close to the markets and its investors, nurturing trust and stability in the euro area financial system. Moreover, with more than €400 billion in available lending capacity, the ESM remains ready for any future crisis affecting the financial stability of its Members.

Investment and Treasury

ESM mitigates paid-in capital losses caused by negative yields.

ESM continues diversifying its portfolios by increasing its hold-to-maturity tranche.

ESM successfully transitions its derivatives activity to the new euro benchmark rate.

ESM ramps up ESG integration in its investment practices.

ESM mitigates paid-in capital losses caused by negative yields

The ESM's paid-in capital stood at €80.5 billion at the end of 2021 and will total €80.8 billion in 2027, when all instalments from existing ESM Members will 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, are invested with an average maturity below 2.5 years; the hold-to-maturity tranche, valued on an amortised cost basis, is invested in securities with maturity at purchase usually beyond 10 years; the €3 billion in reserves, accumulated since inception, are invested in the short-term tranche.

In 2021, the ESM's marked-to-market portfolios recorded a return of -0.97%. Negative market yields led to negative returns on cash deposits and on a large share of ESM assets. In addition, asset valuation fell as European yields rose across maturities, with 10-year yields on the ESM's eligible assets finishing the year on average 50 basis points higher.

As the world economy began to recover from the 2020 pandemic crisis, inflation soared beyond central banks' targets. To mitigate the impact of market developments on its marked-to-market portfolios, the ESM progressively reduced its sensitivity to interest rate risk in anticipation of a gradual withdrawal of ECB accommodative monetary policy. The ESM also kept a significant part of its capital in cash held at several European national central banks, €39.1 billion at the end of the year, rather than investing it in short-term securities priced well below ESM's cash remuneration of -0.50%.

The ESM maintained a diversified exposure in eligible asset classes to benefit from the additional return provided by credit spreads. The share of paid-in capital held in public agency, sub-sovereign, supranational, and covered bonds remained at 43% (Figure 16). The volume of non-euro denominated assets, hedged into euros, rose by €2 billion to reach an €11 billion equivalent, mainly due to increased allocation to US dollar denominated assets, which offered additional returns compared to European assets. The paid-in capital's credit quality remains at a very high level, with 93% of capital held with Eurosystem central banks or invested in assets rated AA- or higher (Figure 17), similar to 2020.

As a result of these actions, the annual performance of these portfolios was two basis points above the long-term benchmarks, taking the outperformance since inception to 19 basis points per year. The benchmarks, which the ESM Board Risk Committee reviews annually, consist of indices of AAA/AA rated euro area government and supranational bonds spread across maturities ranging from zero to 10 years.

The paid-in capital recorded an accounting loss of €59.5 million for the year, including a loss of €66.2 million for the short-term and medium-/long-term tranches. In 2021, the ESM switched its accounting methodology for measuring profit and loss from securities sales from the first-in first-out method to the average cost method, which is more common in financial reporting, produces consistent results, and is less impacted by price changes. The change of methodology increased accounting losses by €0.5 million. The losses on the portfolios were offset by the €216.2 million received by the ESM as compensation for negative interest paid on the ESM's Eurosystem cash deposits in 2020. To ensure that the negative interest environment does not erode ESM's capital, France, Germany, Italy, and the Netherlands have agreed, as a temporary solution and under certain conditions, to return negative interest payments on ESM capital deposited in their national central banks. The accumulated profit on the ESM's capital since inception is €1.785 billion, including €901.4 million extraordinary income from negative interest compensation received from 2018 until the end of 2021.

ESM reinforces its long-term financial strength by increasing the size of its hold-to-maturity tranche

In 2021, the ESM continued building up its hold-to-maturity tranche investments to sustain its long-term financial strength. This portfolio is invested in diversified, highly rated eligible issuers. As of the year end, the portfolio reached €9.9 billion, invested in maturities of seven to 20 years, and generated an annual accounting profit of €7.9 million. The ESM intends to continue gradually expanding this portfolio to benefit from a regular stream of interest.

ESM successfully transitions its derivatives activity to the new euro benchmark rate

To maintain good access to market liquidity and competitive pricing when conducting derivative operations, the ESM adjusted its International Swaps and Derivatives Association credit support annex agreements with its counterparties. The ESM replaced the interest rate reference to EONIA, the main cash rate in the euro area until early January 2022, with the euro short-term rate (€STR), reflecting wholesale euro unsecured overnight borrowing costs of euro area banks. This change came about after market regulators reviewed the methodology for calculating reference market rates to ensure that they robustly and transparently represent financing conditions.

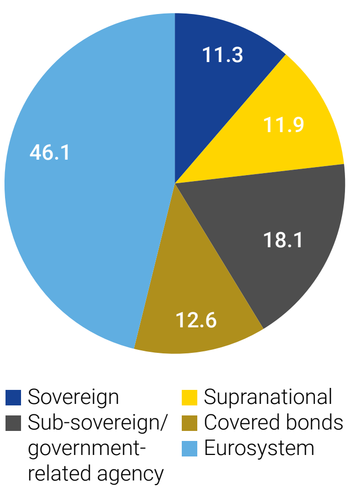
As the new reference rate is set below the previous one, the ESM performed a full revaluation exercise of its swap portfolio with each of its counterparties. The switch generated small changes in ESM's derivatives valuations, which were compensated by one-off net payments to counterparties for a total of -€0.9 million, reflecting the future lower cash collateral remuneration. These payments are recorded as part of the interest receivable/payable in the ESM profit and loss account.

ESM ramps up its ESG integration

The ESM is committed to integrating ESG factors into its investment approach. Since signing the United Nations (UN) backed Principles for Responsible Investment (PRI) in 2020, the ESM has continued reporting on its responsible investment activities and preparing to apply ESG principles to all its paid-in capital in 2022 – in particular, by working to define an ESG score based on issuer ESG performance for its paid-in capital investments.

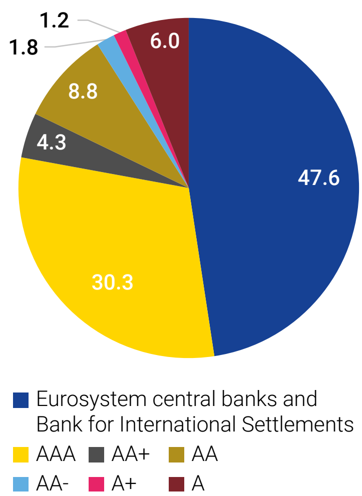
In parallel, the ESM increased its holdings in use-of-proceeds bonds, which reached €8 billion at the end of 2021, a rise from €5.9 billion in 2020 (including a €1.1 billion upward revision of the 2020 reported amount). Of these, €7.7 billion are compliant with the International Capital Market Association principles and guidelines: about 20% are categorised as green bonds and the remaining part is split equally between social and sustainability bonds. The remaining €0.3 billion are 'pandemic' bonds issued by eligible supranational and agency issuers, whose proceeds financed part of the emergency response to the Covid-19 crisis but do not follow the International Capital Market Association principles and guidelines.

Figure 16
Asset class distribution of investments
(in %)



Source: ESM

Figure 17
Ratings distribution of investments
(in %)



Source: ESM

Risk Management

Risk Management helps shape the risk framework for future SRF backstop.

ESM maintains vigilance to ongoing and evolving risks.

ESM expands cyber risk measures.

ESM values interinstitutional risk-related knowledge sharing and building.

ESM improves risk monitoring activities.

Risk Management factors ESG into analyses.

Shaping the risk framework for the SRF backstop

The Risk Management division, in cooperation with other divisions, contributed to developing the ESM's operational readiness for its broadened mandate. The division reviewed ESM risk policies to prepare the risk management and governance procedures for work related to providing the common backstop for the SRF. The common backstop will replace the direct recapitalisation instrument, meaning the ESM will no longer have the potential for equity exposures to banks. The Board Risk Committee will consider the related changes to the risk policies ahead of discussion and approval by the BoD and publication on the ESM website.

Risk Management participated in ESM–SRB dry runs to test the new procedures and governance arrangements. Lessons from the dry runs were incorporated in updates to internal procedures.

ESM maintains vigilance to ongoing and evolving risks

The ESM remained vigilant to ongoing and evolving risks throughout the year. Risk Management closely monitored and reported to the internal risk committee on risk developments, including those arising from the pandemic, and continuously identified issuers and counterparties whose credit profiles were more prone to deterioration. The internal risk committee approved several updates to risk policies and exercised oversight on risks related to the ESM's initiatives and projects.

In 2021, credit rating agencies took negative rating actions on some of the issuers and derivative counterparties to which the ESM was exposed, particularly in the second and third quarters. However, upgrades and more favourable outlooks outweighed negative ratings in the fourth quarter of the year, resulting in fewer negative ratings for 2021 compared to 2020.

The ESM continues to maintain a portfolio of high-quality investment assets, in accordance with ESM's investment guidelines and risk policies.

ESM expands cyber risk measures

As cybersecurity is one of the ESM's top potential risks, Risk Management continued to collaborate closely with the information technology (IT) division to review both new and existing services and products for best practice and industry standard protections against cyberattacks. The Risk Management division's dedicated information security function provided a second line of defence overview on cybersecurity and information security risk and incident prevention, identification, and responses. This included an exercise, in conjunction with the ESM's incident management team, simulating a ransomware attack to inform and enhance ESM's cyber incident response plan.

The ESM also established a new internal IT governance committee in November 2021 to provide oversight on ESM's IT strategy and key decisions related to its implementation, including on information security.

ESM values knowledge sharing and building

In 2021, the ESM continued to exchange best practices with other international financial institutions and peer institutions, including with the Bank for International Settlements, the Council of Europe Development Bank, the EIB, and the Nordic Investment Bank. Risk Management organised and participated in virtual meetings and workshops to share expertise on various risk topics such as ESG – with a focus on climate risk, Covid-19 and its consequences, scenario analyses, methodologies for setting credit limits, and operational risk.

ESM improves automation and risk monitoring

The ESM finalised further risk monitoring automation and enhancements:

- Risk Management further integrated analytics in its market and liquidity risk reporting. The automation of data inflows and outflows enabled system-generated reports on value-at-risk (historical, parametric, Monte Carlo), back testing, market liquidity metrics, and stress testing. This, in turn, allowed for more dynamic and impactful presentation of risk reports at committee level.

- Risk Management developed credit risk dashboards to better monitor and swiftly react to credit rating changes. The team also introduced new risk management software to increase its credit risk analysis capacity. The division will explore and promote the use of other automation tools, such as artificial intelligence and natural language generation software, for use in credit risk reports and analyses.

- Risk Management procured a tool to better manage operational risks by automating and simplifying the process of collecting, storing, analysing, tracking, and reporting information relevant to ESM's operational risk framework.

Risk Management factors ESG into analyses

Risk Management closely follows ESG-related market practices and regulatory developments, including the identification and management of climate risks and the assessment of the impact of ESG factors on issuers' credit strength. Risk Management takes such factors into account on a qualitative basis when assessing risk exposures. Monitoring public information on counterparties' regulatory compliance is an important governance element for the ESM when setting risk limits.

ESG at the ESM

ESM identifies ESG and climate change as one of its strategic priorities for 2022.

ESM incorporates ESG criteria in the review of internal policies on an ongoing basis, and establishes a whistleblowing hotline in February 2021.

ESM progresses in implementing the UN-backed PRI and continues to report on its sustainable investing efforts.

ESM publishes its third carbon footprint report in July 2021.

ESM joins the Network of Central Banks and Supervisors for Greening the Financial System (NGFS) in early 2022.

Environmental

The ESM remains dedicated to protecting the environment and follows a prudent approach on environmental matters. In February 2021, the ESM updated its Code of Conduct, expanding its ESG commitment to continuously monitor, communicate, and further limit its environmental impact.

The ESM published its third carbon footprint report in July 2021 as part of ongoing efforts to monitor, measure, and report the institution's environmental impact. The exercise also serves to guide the design of measures to enhance its environmentally conscious practices and reduce the use of natural resources and energy. The 2020 carbon footprint reflected the shift in the ESM's day-to-day operations and environmental impact due to the Covid-19 pandemic. The ESM adjusted the report's methodology to include teleworking emissions while still remaining comparable to previous reports, allowing for the identification of positive emission trends.

Throughout 2021, the ESM increasingly replaced non-recyclable plastic materials with sustainable alternatives in line with its pledge under the Zero Single-Use Plastic Manifesto.

As a result of these efforts, the ESM received its eighth consecutive certificate for the sound treatment of energy sources and the recycling of waste from the Luxembourg government.

Social

The ESM's Pandemic Crisis Support credit line, established as part of the concerted European response to the financial effects of the Covid-19 pandemic, is available to all euro area countries to finance direct and indirect healthcare, cure, and prevention-related costs stemming from the Covid-19 crisis. The instrument, created in 2020, remains available to ESM Members until the end of 2022. Should a country draw upon the credit line, the ESM intends to issue social bonds, enabling the ESG investor community to allocate funds to support the social needs of euro area member states. For this, the ESM has in place a social bond framework compliant with the International Capital Market Association's social bond principles.

Governance

The ESM has a robust governance framework that ensures strong accountability and transparency towards its shareholders and other stakeholders. In 2021, the ESM established a whistleblowing policy and hotline providing a confidential and anonymous reporting system for ESM staff and the public to reinforce the ESM's commitment to accountability and compliance best practices. During 2021, the ESM continued to embed the UN-backed PRI criteria into its investment processes (for more information, see Investment and Treasury). Furthermore, the ESM continues to closely follow regulatory updates and incorporates climate risk and ESG considerations in the assessment of counterparties' credit strength.

In 2021, the ESM added information on its ESG developments and governance to its webpages dedicated to informing stakeholders and the public. In addition, the ESM regularly and actively engaged with credit rating and ESG rating agencies as well as with investors, peer institutions, and policymakers to inform, shape, and enhance ESG-related thought leadership and objectives. The ESM continued participating as an observer in the European Commission's Platform on Sustainable Finance and as a member in the International Capital

Market Association's Social Bond Working Group, contributing to various public consultations through these two forums. Furthermore, the ESM joined the NGFS in February 2022 and is planning to increasingly incorporate climate change considerations in its analyses and operations. The NGFS offers a platform for central banks, supervisory authorities, and other public institutions to strengthen the financial system's ability to finance the transition to a carbon-neutral economy through the redirection of capital to sustainable investments.

Transparency and accountability

ESM publishes a transparency webpage to offer information on its policies and guidelines, complementing its existing programme database that details ESM's financial assistance operations.

ESM publishes 13 new blog posts featuring topical, mandate-related issues.

The ESM has a number of measures in place to ensure its stakeholders and the public have a good understanding of its mandate and work. Most recently, it has used its ESM reform webpage to provide the public with timely updates on the early 2021 signature of the amended ESM Treaty and agreed package of related documents. The ESM regularly publishes a wide range of policies, legal documents, and governing bodies' decisions regarding its operations and the implementation of its mandate on its transparency webpage.

In 2021, the ESM Managing Director and senior staff participated in various conferences, seminars, academic gatherings, and regular exchanges with national parliaments either virtually or in person. Among these, the Managing Director spoke about EU fiscal reform at the ECB's fifth biennial conference on fiscal policy and EMU governance. Senior managers also spoke on several occasions on the response to the pandemic crisis and the European recovery path in the context of EMU. In addition, ESM senior staff engaged in continuous dialogue with national and international media, resulting in frequent interviews and television appearances, with Bloomberg, CNBC, and leading European newspapers.

Throughout the year, the ESM published 13 blog posts from various managers and staff on a variety of ESM-related topics, including the pandemic response and the road to recovery following the pandemic crisis.

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

The ESM's accountability framework is also underpinned by the BoA's extensive audit oversight. Both the BoA's annual report to the BoG and accompanying comments by ESM management are provided to the national parliaments and supreme audit institutions of the ESM Members, the European Parliament, the European Court of Auditors, and to the public via the ESM website.

03 Institutional framework and organisation

Governance

The BoG meets at least once a year and whenever the affairs of the ESM so require (resulting in one physical meeting and two votes without meeting in 2021). The BoD also meets whenever the affairs of the ESM so require (seven instances in 2021), while the Board Risk Committee and the Budget Review and Compensation Committee normally meet quarterly, and additionally when required.

ESM shareholders

The ESM shareholders are the 19 euro area member states, which are also referred to as ESM Members. ESM Members have contributed to the ESM's authorised capital based on their 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.

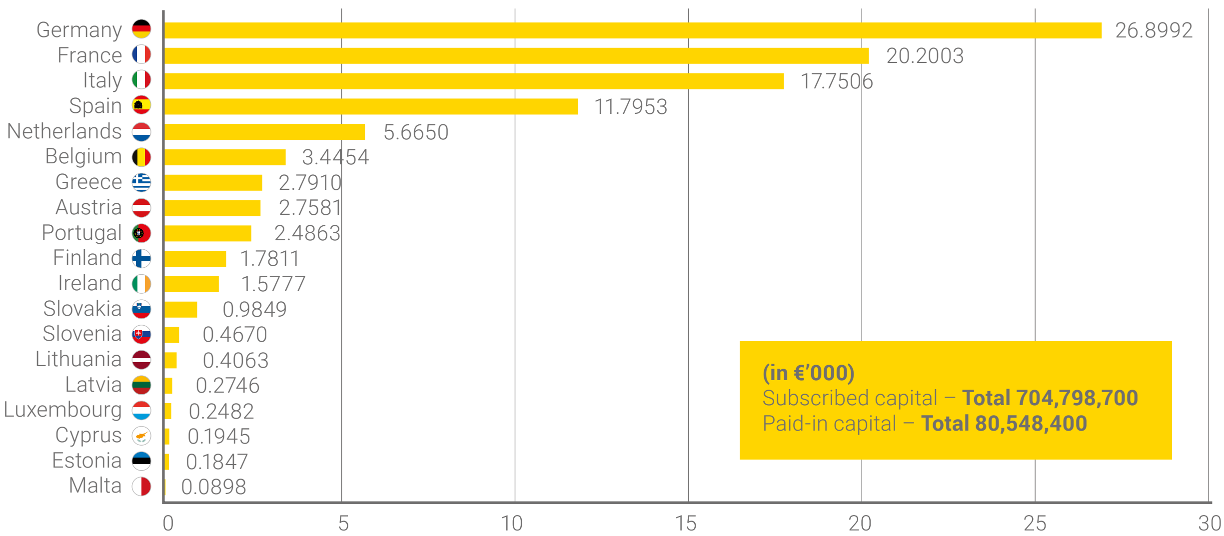
Shareholder engagement

The eighth Shareholders' Day took place in a virtual format on 10 and 11 November 2021. The event gathered representatives from the finance ministries of all 19 ESM Members who work on ESM-related matters, as well as representatives from the European Commission and ECB. Sessions covering policy, research, and operational areas of ESM activity gave participants the opportunity to discuss topics such as the deepening of EMU and the SRF backstop, and to reflect on the ESM's work. A variety of formats, such as virtual poster presentation sessions and interactive simulations, created an engaging and dynamic event that stimulated exchanges of views among participants and strengthened relationships between the ESM and its Members. Speakers included ESM staff, as well as academics and representatives from partner institutions.

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.

ESM contribution key

(in %)



Notes: As of 27 April 2022. 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. Estonia, Latvia, and Lithuania are currently benefitting from temporary corrections, the last of which concludes at the end of 2026.

Visit our website for more information on our governance.

Board of Governors

On 17 June 2021, the BoG held its ninth annual meeting in Luxembourg.

In his presentation to the BoG, the Managing Director highlighted the key achievements of the ESM during the previous year, including the ESM's response to the Covid-19 pandemic, ESM operations, and the ESM Treaty reform. In addition, the Chairperson of the BoA addressed the Governors regarding the BoA's annual report to the BoG, as well as the BoA's report in respect of the ESM 2020 financial statements. Furthermore, the external auditor presented its report in respect of the audit of the ESM 2020 financial statements.

At this meeting, the BoG approved the ESM 2020 Annual Report as drawn up by the ESM Managing Director and benefitted from a virtual address by the IMF Managing Director, Kristalina Georgieva. In her address, Ms Georgieva discussed the outlook for the global recovery from the Covid-19 pandemic, the role of the Regional Financing Arrangements within the global financial safety net, and the new allocation of special drawing rights.

Visit our website for more information on the BoG.

Members of the Board of Governors

Paschal Donohoe

Ireland

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

Vincent Van Peteghem

Belgium

Deputy Prime Minister and Minister of Finance,
Governor since 1 October 2020

Christian Lindner

Germany

Federal Minister of Finance,
Governor since 8 December 2021
– Replacing Olaf Scholz,
Governor since 14 March 2018

Keit Pentus-Rosimannus

Estonia

Minister of Finance,
Governor since 26 January 2021
– Replacing Martin Helme,
Governor since 29 April 2019

Christos Staikouras

Greece

Minister of Finance,
Governor since 11 July 2019

Nadia Calviño

Spain

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

Bruno Le Maire

France

Minister of Economy and Finance,
Governor since 25 May 2017

Daniele Franco

Italy

Minister of Economy and Finance,
Governor since 13 February 2021
– Replacing Roberto Gualtieri,
Governor since 5 September 2019

Constantinos Petrides

Cyprus

Minister of Finance,
Governor since 3 December 2019

Jānis Reirs

Latvia

Minister of Finance,
Governor since 19 February 2019

Gintarė Skaistė

Lithuania

Minister of Finance,
Governor since 11 December 2020

Yuriko Backes

Luxembourg

Minister of Finance,
Governor since 5 January 2022
– Replacing Pierre Gramegna,
Governor since 4 December 2013

Clyde Caruana

Malta

Minister of Finance and Employment,
Governor since 23 November 2020

Sigrid Kaag

Netherlands

Deputy Prime Minister and Minister of Finance,
Governor since 10 January 2022
– Replacing Wopke Hoekstra,
Governor since 26 October 2017

Magnus Brunner

Austria

Federal Minister of Finance,
Governor since 20 December 2021
– Replacing Gernot Blümel,
Governor since 4 February 2020

Fernando Medina

Portugal

Minister of Finance,
Governor since 30 March 2022
– Replacing João Leão,
Governor since 15 June 2020

Andrej Šircelj

Slovenia

Minister of Finance,
Governor since 13 March 2020

Igor Matovič

Slovakia

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

Annika Saarikko

Finland

Minister of Finance,
Governor since 27 May 2021
– Replacing Matti Vanhanen,
Governor since 17 June 2020

Board of Directors

Members of the Board of Directors

Klaus Regling

Chair of the Meetings of the Board of Directors

ESM Managing Director

Steven Costers

Belgium

Counsellor General,
Ministry of Finance,
appointed on 1 May 2015

Carsten Pillath

Germany

State Secretary, Federal Ministry of Finance,
appointed on 13 January 2022
– Replacing Jörg Kukies,
appointed on 9 April 2018
– Member of the Board Risk Committee
since 22 February 2022,
appointed until 8 October 2023

Märten Ross

Estonia

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

Gary Tobin

Ireland

Assistant Secretary General,
International and EU Division,
Department of Finance,
appointed on 8 July 2019

Michael Arghyrou

Greece

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

Carlos Cuerpo

Spain

Secretary General of Treasury and
International Financing,
Ministry of Economic Affairs and Digital
Transformation,
– Replacing Carlos San Basilio,
appointed on 19 June 2018
– Member of the Board Risk Committee
since 23 September 2021,
appointed until 8 October 2023

Emmanuel Moulin

France

Director General of the Treasury,
Ministry of Economy, Finance, and Recovery,
appointed on 9 November 2020
– Member of the Budget Review and
Compensation Committee since
23 November 2020,
appointed until 8 October 2023

Alessandro Rivera

Italy

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,
reappointed until 8 October 2024

George Panteli

Cyprus

Permanent Secretary,
Ministry of Finance,
appointed on 29 April 2013

Līga Kļaviņa

Latvia

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

Mindaugas Liutvinskas

Lithuania

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

Nima Ahmadzadeh

Luxembourg

Director of Economic and Fiscal Affairs,
Ministry of Finance,
appointed on 26 July 2019
– Member of the Budget Review and
Compensation Committee since
5 September 2019,
reappointed until 8 October 2024

Alfred Camilleri

Malta

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

Christiaan Rebergen

Netherlands

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

Harald Waiglein

Austria

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

João Nuno Mendes

Portugal

Secretary of State for the Treasury,
Ministry of Finance,
appointed on 15 June 2020

Katja Lautar

Slovenia

State Secretary, Ministry of Finance,
appointed on 19 February 2019

Peter Paluš

Slovakia

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

Leena Mörttinen

Finland

Permanent Under-Secretary,
Ministry of Finance,
appointed on 5 November 2020

Board of Auditors

The BoA is an independent oversight body of the ESM that inspects the ESM accounts, conducts audits on the regularity, compliance, performance, and risk management of the ESM, 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. In October 2021, the BoG appointed two new BoA members, Jochen Wenz and Akis Kikas, for non-renewable terms of three years, to replace Irena Petruškevičienė and Noel Camilleri, whose mandates had come to an end. Furthermore, the BoG appointed Lucia Kašiarová in April 2022 to replace Tommaso Fabi, whose term had also ended.

In 2021, the BoA held eight meetings, with six of these meetings taking place virtually. During these meetings, ESM management and senior staff updated the BoA on ESM activities, the decisions of the ESM governing bodies, and other relevant issues and developments. Throughout the year, the BoA regularly met with the ESM's internal audit function and monitored and reviewed the work of the external auditors. In addition, the BoA Chairperson met once with the Board Risk Committee Chairperson and once with the BoD. The BoA Chairperson also met with the BoG Chairperson at the Annual Meeting of the BoG, to discuss the audit work and reports issued by the BoA, namely its report on the ESM financial statements and its annual report to the BoG.

The BoA also concluded, with the support of subject-matter experts from the European Court of Auditors, its audit on ESM Human Resource recruitment processes. In fulfilling its role, the BoA reviewed the ESM 2021 financial statements and the working papers of the external auditor.

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

Ilias Dimitriadis
Vice-chairperson since 27 April 2022
Member since 8 October 2019
Appointed upon nomination by the Supreme Audit Institution of Greece (Hellenic Court of Audit)

Tommaso Fabi
Vice-chairperson from 20 October 2021 to 31 March 2022
Member from 1 April 2019 to 31 March 2022
Appointed upon proposal by the Chairperson of the Board of Governors

Akis Kikas
Member since 8 October 2021
Appointed upon nomination by the Supreme Audit Institution of Cyprus (Audit Office of the Republic of Cyprus)

Jochen Wenz
Member since 8 October 2021
Appointed upon proposal by the Chairperson of the Board of Governors

Lucia Kašiarová
Member since 25 April 2022
Appointed upon proposal by 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. It is underpinned by the three lines governance model established by the BoD and is aligned with the principles of the Basel Committee's Framework for Internal Control Systems in Banking Organisations.[3]

The Managing Director, under the direction of the BoD, is responsible for the maintenance of the 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 ESM internal controls to the BoD, via the Board Risk Committee, and to the BoA, with a copy extended to the ESM external auditor. The management report on internal controls as of 31 December 2021 does not indicate material or significant internal control weaknesses.

Visit our website for more information on our internal control framework.

ENTITY-LEVEL CONTROLS

include management oversight and control culture, risk recognition and assessment, 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.

IT CONTROLS

include IT general controls, IT security, and IT application controls embedded in ESM systems.

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

ESM organisational structure

The Management Board assists the Managing Director in conducting the current business of the ESM, specifically in preparing the decisions of the BoG and the BoD and in seeing to their implementation. Alongside the Managing Director, the Management Board comprises the Deputy Managing Director and Chief Risk Officer; the Chief Operating Officer; the General Counsel; the Secretary General; the Chief Financial Officer; and the Chief Economist.

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

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 2021, the total ESM balance sheet was €827.0 billion. Compared to the previous year, it decreased by €1.6 billion, mainly due to a €0.6 billion decrease in *Debt evidenced by certificates* in relation to the lower rollover of maturing bonds and a decrease of almost €1 billion in the *Fair value reserve* linked to investments in debt securities.

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 €0.2 billion compared to 31 December 2020, from €44.2 billion to €44.4 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 2021, this reserve was negative €44.7 million, compared to positive €913.4 million as of 31 December 2020. The decrease reflects the lower market value of securities investments compared to the previous year, largely due to the increase in interest rates that affected the market yields.

Profit and loss account

The ESM recorded a net income of €311.0 million for the financial year 2021, compared to €392.9 million in 2020. It is mainly composed of the amounts received from Germany, France, Italy, and the Netherlands to compensate the ESM for the negative interest paid on the cash of the paid-in capital and reserves held at their national central banks in 2020. These compensations, totalling €216.2 million, were recorded as *Extraordinary income* as of 31 December 2021.

The *Profit before extraordinary items*, which corresponds to the net income generated by ESM operations, decreased by €62.4 million, to €94.9 million in 2021 from €157.3 million in 2020. The decrease was driven by the *Net profit on financial operations*, which declined by €59.3 million to €149.0 million in 2021 from €208.3 million in 2020.

Operating costs, including depreciation of tangible and intangible assets, were €81.3 million in 2021 compared to €76.1 million in 2020. The increase is mainly due to higher staff cost. The ESM provides administrative services to the EFSF and received a service fee of €33.1 million in 2021 (€33.1 million in 2020), which is recognised as *Other operating income*. The ESM continues to focus on budgetary discipline and effective cost control.

Outlook for 2022

The ESM continues to diversify its investments and regularly adjusts the portfolio exposure to mitigate the impact of negative yields on the return of the paid-in capital, in line with its guidelines and its mandate. However, as European yields continued their rise across maturities that began at the end of last year, asset valuation continues to fall. The persistence of this environment is likely to affect the ESM's net income in 2022.

In 2021, the ESM Members signed the Agreement Amending the Treaty Establishing the ESM. In 2022, when the ratification of the Treaty by all national parliaments will be completed, the ESM will become the backstop to the Single Resolution Board (SRB) for the Single Resolution Fund (SRF), taking a step closer towards completing banking union. The revised treaty will also give the ESM a stronger role in future economic adjustment programmes and crisis prevention.

In February 2022, following Russia's invasion of Ukraine, all EU countries and many others worldwide started imposing heavy financial and commercial sanctions on Russia. Beyond the impact on Russia, the sanctions influence financial markets and economies globally. The ESM's activities may be affected as well. Given the uncertainty of the situation, it is currently not possible to assess possible effects on the ESM's net income in 2022. The ESM will continue to closely monitor the situation to be ready to implement mitigating actions, as needed.

Balance sheet

As at 31 December 2021
(In €'000)

	Notes	31.12.2021	31.12.2020
ASSETS			
Cash in hand, balances with central banks and post office banks	4	60,401,825	58,217,164
Loans and advances to credit institutions			
(a) other loans and advances	5	7,098,396	11,084,040
		7,098,396	11,084,040
Loans and advances to euro area member states	6	89,867,531	89,894,688
Debt securities including fixed-income securities	7		
(a) issued by public bodies		21,687,738	22,292,608
(b) issued by other borrowers		22,751,012	21,959,682
		44,438,750	44,252,290
Intangible assets	8	23	7
Tangible assets	9	4,369	5,451
Subscribed capital unpaid	15	624,250,300	624,250,300
Prepayments and accrued income	10	977,392	898,944
Total assets		827,038,586	828,602,884
LIABILITIES			
Amounts owed to credit institutions	11	1,006,032	983,059
Debts evidenced by certificates	12		
(a) debt securities in issue		116,906,551	117,511,345
		116,906,551	117,511,345
Other liabilities	13	9,535	11,565
Accruals and deferred income	14	1,020,107	1,353,476
Total liabilities		118,942,225	119,859,445
SHAREHOLDERS' EQUITY			
Subscribed capital	15	704,798,700	704,798,700
Fair value reserve	7	(44,749)	913,359
Reserve fund	2.8.1/16	3,031,380	2,638,464
Profit for the financial year		311,030	392,916
Total shareholders' equity		708,096,361	708,743,439
Total equity and liabilities		827,038,586	828,602,884

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

Off-balance sheet

As at 31 December 2021
(In €'000)

	Notes	31.12.2021	31.12.2020
OFF-BALANCE SHEET			
Other items	3.6/25		
(a) notional value of interest rate swaps			
- interest rate swaps		71,565,500	67,755,500
(b) notional value of cross-currency asset swaps			
- receivable		20,066,650	15,682,419
- payable		(19,957,931)	(15,916,704)
(c) notional value of futures contracts			
- bond futures		556,500	-
- interest rate futures		200,000	-

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

Profit and loss account

For the financial year ending 31 December 2021
(In €'000)

	Notes	2021	2020
Interest receivable and similar income			
(a) on loans and advances to credit institutions		26,502	12,222
(b) on loans and advances to euro area member states	17	1,001,397	1,127,151
(c) on debt securities including fixed-income securities	18	158,221	139,844
(d) on debts issued		223,053	162,147
(e) other	25	557,114	460,526
		1,966,287	**1,901,890**
Interest payable and similar charges			
(a) on cash and cash equivalents	19	(291,916)	(309,191)
(b) on loans to credit institutions		(61,579)	(52,008)
(c) on debts issued		(670,794)	(804,892)
(d) on debt securities including fixed-income securities	18	(25,937)	(18,339)
(e) other	25	(922,202)	(725,766)
		(1,972,428)	**(1,910,196)**
Commissions payable		**(38)**	**(36)**
Other operating income	20	**35,100**	**35,089**
Net profit on financial operations	7/21	**149,016**	**208,292**
General administrative expenses			
(a) staff costs	22	(38,977)	(36,848)
- wages and salaries		(28,900)	(26,721)
- social security		(10,077)	(10,127)
of which relating to pension		*(8,598)*	*(8,924)*
(b) other administrative expenses	23	(42,346)	(39,214)
		(81,323)	**(76,062)**
Value adjustments in respect of intangible and tangible assets	8/9	**(1,765)**	**(1,712)**
Profit before extraordinary items		**94,849**	**157,265**
Extraordinary income	24	**216,181**	**235,651**
Profit for the financial year		**311,030**	**392,916**

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

Statement of changes in equity

For the financial year ending 31 December 2021
(In €'000)

	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**

	Subscribed capital	Fair value reserve	Reserve fund	Profit brought forward	Profit for the financial year	Total
At 1 January 2021	**704,798,700**	**913,359**	**2,638,464**	**-**	**392,916**	**708,743,439**
Allocation of 2020 profit	-	-	-	392,916	(392,916)	-
Allocation of profit brought forward to the reserve fund	-	-	392,916	(392,916)	-	-
Profit for the financial year	-	-	-	-	311,030	**311,030**
Change in fair value reserve	-	(958,108)	-	-	-	**(958,108)**
At 31 December 2021	**704,798,700**	**(44,749)**	**3,031,380**	**-**	**311,030**	**708,096,361**

Statement of cash flows

For the financial year ending 31 December 2021
(In €'000)

	2021	2020
Cash flows from operating activities:		
Profit for the financial year	311,030	392,916
Adjustments for value adjustments in respect of tangible and intangible assets	1,765	1,712
Changes in tangible and intangible assets	(699)	(678)
Changes in other liabilities	(2,030)	741
Changes in accrued interest and interest received	(1,188,126)	(1,311,973)
Changes in prepayments	(132,618)	(40,767)
Changes in accruals and deferred income and interest paid	423,083	843,169
Interest received	1,242,296	1,316,904
Interest paid	(756,452)	(826,479)
Net cash flow (used in)/provided by operating activities	**(101,751)**	**375,545**
Cash flows from investing activities		
Changes in debt securities including fixed-income securities	(1,144,568)	(10,210,739)
Changes in loans and advances to credit institutions	3,985,644	(4,671,151)
Loan repayments received during the year	27,157	-
Changes in amounts owed to credit institutions	22,973	652,109
Net cash flow provided by/(used in) investing activities	**2,891,206**	**(14,229,781)**
Cash flows from financing activities		
Changes in debt securities in issue	(604,794)	7,098,251
Net cash flow (used in)/provided by financing activities	**(604,794)**	**7,098,251**
Net increase/(decrease) in cash and cash equivalents	2,184,661	(6,755,985)
Cash and cash equivalents at the beginning of the financial year	58,217,164	64,973,149
Cash and cash equivalents at the end of the financial year	**60,401,825**	**58,217,164**

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 2021 to 31 December 2021, while comparative figures cover the period from 1 January 2020 to 31 December 2020.

Following a proposal from the Managing Director, the Board of Directors adopted the financial statements on 28 March 2022 and authorised their submission to the Board of Governors for approval at its 16 June 2022 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 rele-

vant 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 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 2021 and 2020, 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 2021 and 2020 is €23.7 billion (see 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 2021 and 2020 is €6.3 billion (see 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.

On 15 June 2021, Greece repaid €27.2 million using part of the dividends received from the Hellenic Corporation of Assets and Participations (HCAP). This is in line with the agreed repayment mechanism for funds received by the State from HCAP.

The outstanding nominal amount of loans granted to Greece as at 31 December 2021 is €59.8 billion (31 December 2020: €59.9 billion) (see 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 of 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 2021.

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[4] 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 2.4.

2.2. CHANGES IN ACCOUNTING POLICIES

As of 1 January 2021, the ESM changed the accounting policy for the calculation of the net profit from sales of securities, included in "Debt securities including fixed income securities", from FIFO (first-in-first-out) to AVCO (average cost) to align with common business and accounting practice in financial institutions. The effect of the change on the existing portfolio was recognised as a one-off charge for the period, which is included in "net profit on financial operations" within the profit and loss account. Further disclosures are provided in Notes 7, 18, and 21 in relation to this change in the accounting policy.

2.3. BASIS OF MEASUREMENT

The accompanying financial statements are prepared on a historical cost basis, except for debts evidenced by certificates which are measured at amortised cost, and part of the paid-in capital and reserve fund investments which are measured at fair value with gains and losses recognised in the fair value reserve. 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.

2.4. 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 (see Note 2.9). 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 2021 and 2020, thus none has been recorded.

[4] 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.

2.5. 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.

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.

2.6. 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[5] (see Note 3.3.2), and interest rate swaps to manage the interest rate risk exposure (see 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 short-term interest rate and bond futures contracts to manage the interest rate risk of the paid-in capital portfolios (see Note 3.3.1). The futures transactions are booked at notional amount as off-balance sheet items at the date of the transaction.

2.6.1. 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 instruments. 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.

2.6.2. 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'.

[5] 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.

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.

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'.

2.6.3. 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 short-term 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 (or vice versa if the interest rate is negative).

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'.

2.6.4. INTEREST RATE BENCHMARK REFORM (IRBR)

Interest rate benchmarks, such as the Euro OverNight Index Average (EONIA), are widely used in financial contracts. In recent years, confidence in their reliability and robustness has been undermined, and regulators across the globe have been pushing for a reform of interest rate benchmarks. The global transition to alternative interest rate benchmark rates replacing Interbank Offered Rates (IBORs) for different currencies is one of the most challenging reforms to be undertaken in the financial markets with major main milestones due to be achieved by the end of 2021.

In September 2017, the European Central Bank (ECB), the Financial Services and Markets Authority (FSMA – Belgian market supervisor), the European Securities and Markets Authority (ESMA) and the European Commission announced the launch of the industry working group on euro risk-free rates (RFR). The working group was tasked with identifying and recommending risk-free rates that could serve as an alternative to the current benchmarks used in a variety of financial instruments and contracts in the euro area and with developing adoption plans.

In September 2018, the working group recommended that the euro short-term rate (€STR) become the successor to EONIA. In order to ensure smooth market adoption, there will be a two-year transition period in two phases.

The first phase dealt with pre-replacement issues (issues affecting financial reporting in the period before the replacement of an existing interest rate benchmark). The first phase of the project culminated with the Interest Rate Benchmark Reform amendments published in September 2019.

The second phase of the project dealt with replacement issues (issues that might affect financial reporting when an existing interest rate benchmark is replaced). To address it, a dedicated sub-working group on financial accounting and risk management has been created to specifically analyse the impact on financial accounting and risk management of the transition from EONIA to €STR. The sub-group comprised representatives of European and international credit institutions (including the ESM), consulting and accounting firms, clearing houses, investment management firms and associations. The ECB, ESMA, the European Commission, and the FSMA act as observers in the sub-group.

The potential discontinuation of such benchmarks raises the question of how contracts indexed to them (swaps only for the ESM) will be affected. In case the market standards do not lead to the discontinuation of the various IBORs in a consistent way, this could expose the ESM to basis risks between the various versions of IBORs' successors. The exposure to basis risks is not specific to the ESM and it has been recognised in the IBOR Global Benchmark Transition Report, published by the largest industry associations in June 2018, as one of the biggest challenges in the benchmark reform.

In addition, as already highlighted by the ECB, the banking industry is exposed to the following risks: operational challenges associated with amendments of contracts and introduction of fallback provisions can entail an operational burden, impact on booking infrastructure, adjustments to settlement and payment infrastructures, IT-related restrictions with regard to the valuation and booking of new products based on the reformed reference rates and corresponding valuation methodologies.

Changes to the basis for determining contractual cash flows as a result of interest rate benchmark reform are required, as a practical expedient, to be treated as changes to a floating interest rate, provided that, for the financial instrument, the transition from the IBOR benchmark to RFR takes place on an economically equivalent basis.

In the context of IBOR reform, the ESM's assessment of whether a change to an amortised cost financial instrument is substantial, which was made after applying the practical expedient introduced by IBOR reform during the second phase. This requires the transition from an IBOR to an RFR to be treated as a change to a floating interest rate, where the effective interest rate will be updated without modifying the carrying amount of the financial instrument.

As part of its investment and funding activities, the ESM is only exposed to IBOR transition on derivative instruments used for risk management purposes.

As a consequence of the reform, the new rate called euro short-term rate (€STR) replaced the EONIA and became the official euro risk-free-rate (RFR) benchmark on 3 January 2022. As a result, since 1 October 2019, EONIA is no longer computed but calculated as €STR +8.5bp. This reform had an impact on all remunerations and valuations currently based on EONIA (i.e. derivatives for the ESM). For derivatives, this affected the remuneration of posted derivatives collateral as well as the discounting rate used for the valuation of existing and future interest rate- and cross-currency swaps.

The transition to €STR flat from EONIA flat for the remuneration of cash collateral for derivatives and consequently of the discount curve (CSA based discounting) resulted in one-off compensation fee payments to offset the mark-to-market losses that one counterparty faced following the shift of the discount curve by around 8.5 bps. The purpose of the compensation was to maintain the same financial status as before the change for both counterparties to the contract (net zero impact).

In 2021, the ESM already agreed with all existing commercial counterparties the transition to €STR and received or paid compensation accordingly. The compensation payments were agreed and paid separately for the outstanding funding and investment exposures with each counterparty. The one-off cash compensation is recognised in the ESM's profit and loss account at trade date for the investment-related activities (see Note 25). The compensation received for the funding activity-related derivatives (see Note 3.6.1) was directly and fully retroceded to the beneficiary Member States.

2.7. 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.

2.8. DEBT SECURITIES INCLUDING FIXED-INCOME SECURITIES

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

2.8.1. 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 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 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 liquidity, the availability of maximum lending volume and the creditworthiness of the ESM.

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 (see 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 (STT)

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/ Long-term tranche (MLTT)

The main objective of the Medium/ 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 (HTMT)

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.

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;

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, within an appropriate timeframe and manner to minimise any impact on market prices.

The paid-in capital and the reserve fund investments in the Short-term and Medium/ 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.

As of 1 January 2021, the ESM has changed the accounting policy for the calculation of net profit of the securities sales from FIFO (first-in-first-out) to AVCO (average cost). This change led to a one-off charge for the period, which is included in the net profit on financial operations (see Note 7 and Note 21).

2.8.2. 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 2.8.1.

2.8.3. 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.

2.9. 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 (see Note 2.18).

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 (see Note 2.4) 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 (see Note 5).

2.10. 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.

2.11. 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 the building's 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.

2.12. 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 (see Note 2.6).

2.13. 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 (see Note 2.18). 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 (see Note 11).

2.14. 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 (see Note 2.18).

2.15. 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.

2.16. SUBSCRIBED CAPITAL

On 31 December 2021 and 31 December 2020, 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'.

2.17. 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 includes the spot revaluation, spread amortisation and also the accrued interest expense of ongoing derivative transactions (see Note 2.6).

2.18. 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.

2.19. 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.

2.20. COMPENSATION PAYMENTS FROM ESM MEMBERS

Payments received from a Member State as compensation for expenses or losses (see 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.

2.21. 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 the ESM website) and its 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 its 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 maintain 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.

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 is 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 the ESM's information security policy and conducts periodic reviews of user access to information.

Covid-19 pandemic impact and risk management response

In 2021, the euro area countries showed a strong rebound in economic development after the significant drop in GDP they saw in 2020 in the context of the pandemic and the global recession. Robust national and EU-level policy responses have helped to contain the consequences of the pandemic. Moreover, progress in vaccinations and the opening of economic sectors helped economies to grow again. In addition, all euro area countries including the ESM beneficiary Member States (BMS), continued to maintain favourable market access.

During 2021, 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, have and are expected to continue 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 vulnerable ones, represents a remarkable balancing element. Considering all these elements, as of 31 December 2021 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 stable.

Risk Management also continued to closely monitor credit risk developments of ESM investment/funding issuers and counterparties, and in particular those issuers and counterparties whose ratings were identified to be more at risk of facing downward rating pressures amid the Covid-19 pandemic. In stark contrast to 2020, credit rating agencies took several positive credit rating actions on ESM investment/funding issuers and counterparties. The agencies thereby reversed some of the negative actions they took in 2020. In particular, rating agencies' views on financial institutions became more positive in 2021, due to improving economic conditions and better than expected performance through the pandemic. Risk Management reported on relevant credit risk developments, which were discussed in the Internal Risk Committee and in the Board Risk Committee on a quarterly basis.

Brexit and risk management response

The United Kingdom (UK) formally exited the European Union (EU) on 29 March 2019. Subsequently, 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.

Following the agreement reached between the EU and the UK, the ESM decided to again allow for investments in UK-based issuers, including sovereign bonds. As at 31 December 2021, the ESM does not have any investment exposure to UK-based assets but only some GBP-denominated investments (hedged back to euro) from highly rated issuers based outside the UK.

In terms of derivative exposure, the ESM materially reduced derivative trades to UK-based banks from the period 2019 to 2021 by novating its exposure to EU-based banks. As of 31 December 2021, the ESM had no derivative exposure to UK-based derivative counterparties.

3.2. CREDIT RISK

Credit risk is defined as the potential for loss arising from the inability of a counterparty, issuer, or other obligor to fulfil its contractual obligations for full value when due as a result of a significant deterioration in creditworthiness. Counterparty risk includes potential for loss arising from default of a counterpart to derivatives contracts, which are used by both investment and funding activities for risk management. Issuer risk is 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 31.12.2021	Exposure 31.12.2020
Cash in hand, balances with central banks and post office banks	60,401,825	58,217,164
Loans and advances to credit institutions	7,098,396	11,084,040
Debt securities including fixed-income securities	44,438,750	44,252,290
On balance sheet credit risk exposure	**111,938,971**	**113,553,494**
Exposure at default on derivatives [1]	1,651,622	1,309,518
Credit risk exposure	**113,590,593**	**114,863,012**

[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 3.2.4.

(in €'000)	Credit rating[1]	Clean carrying value 31.12.2021
Cash in hand, balances with central banks and post office banks	not rated[2]	60,395,136
	AA	6,689
Loans and advances to credit institutions	not rated[3]	949,799
	AA	1,107,053
	AA-	403,299
	A+	2,811,275
	A	344,590
	A-	1,482,380
Debt securities including fixed-income securities	AAA	25,688,225
	AA+	3,635,186
	AA	7,480,937
	AA-	1,485,344
	A+	1,028,412
	A	5,120,646
Total		**111,938,971**

[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 placed with Eurex Clearing, which are not rated.

(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 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 daily 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/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/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/Long-term tranche, together with the Hold-to-maturity tranche valued at amortised cost, 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 considering prevailing market conditions.

- For the Medium/Long-term tranche, the capital shall be preserved at a three-year horizon for a high level of confidence, to the extent possible considering 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 analyse the market value evolution of the Short-term and the Medium/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 (IMC).

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/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 periods 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 2021 and 2020, 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 (see 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 and 9 September 2021, the ESM raised respectively $3.0 billion and $2.0 billion, and the ESM has hedged the proceeds back into euros (see Note 3.6.1.2).

As 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 2021 (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	60,401,825	-	-	-	-	**60,401,825**
Loans and advances to credit institutions	7,098,396	-	-	-	-	**7,098,396**
Loans and advances to euro area member states	89,867,531	-	-	-	-	**89,867,531**
Debt securities including fixed-income securities	33,007,675	4,664,193	5,486,739	266,358	1,013,785	**44,438,750**
Prepayments and accrued income	906,076	2,530	67,568	1,218	-	**977,392**
Total financial assets	**191,281,503**	**4,666,723**	**5,554,307**	**267,576**	**1,013,785**	**202,783,894**
LIABILITIES						
Amounts owed to credit institutions	1,006,032	-	-	-	-	**1,006,032**
Debt securities in issue	108,096,457	-	8,810,094	-	-	**116,906,551**
Other liabilities	9,535	-	-	-	-	**9,535**
Accruals and deferred income	891,375	51,621	75,842	1,269	-	**1,020,107**
Total financial liabilities	**110,003,399**	**51,621**	**8,885,936**	**1,269**	**-**	**118,942,225**
Shareholders' equity[1]	83,846,061	-	-	-	-	**83,846,061**
Total shareholders' equity	**83,846,061**	**-**	**-**	**-**	**-**	**83,846,061**
Off-balance sheet derivatives	**2,291,444**	**(4,614,458)**	**3,358,026**	**(268,285)**	**(1,014,508)**	**(247,781)**
Net of financial position	**(276,513)**	**644**	**26,397**	**(1,978)**	**(723)**	**(252,173)**

[1] Excluding subscribed capital unpaid.

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.

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 daily 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 market 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 2021, the ESM's liquidity buffer stood at €21.1 billion (2020: €18.3 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 based on the period remaining between the balance sheet date and the contractual maturity date.

31 December 2021 (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	60,401,825	-	-	-	**60,401,825**
Loans and advances to credit institutions	7,098,396	-	-	-	**7,098,396**
Loans and advances to euro area member states	-	-	2,215,000	87,652,531	**89,867,531**
Debt securities including fixed-income securities	61,820	2,365,985	13,368,076	28,642,869	**44,438,750**
Prepayments and accrued income	490,759	485,600	118	542	**977,019**
Total financial assets	**68,052,800**	**2,851,585**	**15,583,194**	**116,295,942**	**202,783,521**
LIABILITIES					
Amounts owed to credit institutions	1,006,032	-	-	-	**1,006,032**
Debt securities in issue	16,790,867	19,482,261	41,302,182	39,331,241	**116,906,551**
Other liabilities	9,535	-	-	-	**9,535**
Accruals and deferred income	258,498	427,426	52,290	281,520	**1,019,734**
Total financial liabilities	**18,064,932**	**19,909,687**	**41,354,472**	**39,612,761**	**118,941,852**
Shareholders' equity(1)	-	-	-	83,846,061	**83,846,061**
Total shareholders' equity(2)	**-**	**-**	**-**	**83,846,061**	**83,846,061**
Net of financial position	**49,987,868**	**(17,058,102)**	**(25,771,278)**	**(7,162,880)**	**(4,392)**

(1) Excluding subscribed capital unpaid.
(2) Shareholder equity has no defined maturity.

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.

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;
- legal and conduct;
- regulatory compliance;
- third party;
- fraud;
- business continuity and technology;
- information security (including Cyber);
- data management;
- people; 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 2021 and in 2020.

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 was working in a full telework set-up since the beginning of the Covid-19 pandemic and had operated smoothly thanks to the Business Continuity framework. During 2021, the ESM has adopted a hybrid work set-up, where employees are allowed to work partly from the office and partly from home. No operational risk events had a direct link to this hybrid work set-up during 2021.

3.6. DERIVATIVES

The ESM uses derivative instruments as described in Note 2.6 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 short-term interest rate futures to manage the interest rate risk of the paid-in capital portfolio.

On 31 December 2021, the derivative instruments had a maximum maturity up to 30 years (2020: maximum maturity up to 30 years) and were concluded with 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)	31.12.2021	31.12.2020
Notional amount	58,710,000	57,790,000
Positive fair value	735,724	1,435,610
Negative fair value	(7,261,579)	(11,823,214)

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 (see 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)	31.12.2021	31.12.2020
Notional amount	8,829,242	6,519,436
Positive fair value	232,434	-
Negative fair value	(17,432)	(239,636)

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 positions as at 31 December 2021 and as at 31 December 2020.

3.6.2. INVESTMENT-RELATED DERIVATIVES

The derivatives used in the context of investment activity are:

- Interest rate swaps;
- Cross-currency asset 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)	31.12.2021	31.12.2020
Notional amount	12,855,500	9,965,500
Positive fair value	99,444	56,486
Negative fair value	(156,674)	(349,018)

3.6.2.2. 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)	31.12.2021	31.12.2020
Notional amount	11,237,408	9,162,983
Positive fair value	100,380	164,944
Negative fair value	(302,425)	(224,036)

3.6.2.3. FUTURES CONTRACTS

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

The following tables show the bond and short-term interest 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)	31.12.2021	31.12.2020
Notional amount	556,500	-

Interest rate futures contracts (in €'000)	31.12.2021	31.12.2020
Notional amount	200,000	-

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)	31.12.2021	31.12.2020
Current account balances with euro area central banks[1]	60,395,136	58,215,304
Current account balances with other banks[2]	6,689	1,860
Total cash in hand, balances with central banks and post office banks	**60,401,825**	**58,217,164**

[1] During the financial year, the ESM held balances with national central banks from France (Banque de France), Germany (Deutsche Bundesbank), Italy (Banca d'Italia) and the 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)	31.12.2021	31.12.2020
Cash collateral provided	6,146,994	10,101,890
Reverse repos	949,799	980,547
Other deposits	1,603	1,603
Total loans and advances to credit institutions	**7,098,396**	**11,084,040**

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 (see 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 2021
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	59,846,071	59,846,071
Total	**25**	**89,867,531**	**89,867,531**

(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**

The following table shows the movements of the loans to euro area member states during 2020 and 2021:

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

(in €'000)	
1 January 2021 balance	**89,894,688**
New disbursements	-
Early repayments	(27,157)
- from Greece	*(27,157)*
31 December 2021 balance	**89,867,531**

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 2021, the overall credit quality of the ESM loans portfolio remained satisfactory.

7. Debt securities including fixed-income securities

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

31.12.2021 (in €'000)	Amortised cost	Unrealised gains	Carrying amount	Nominal amount
Short-term, Medium/ Long-term tranche	34,580,515	(44,749)	34,535,766	34,373,801
Hold-to-maturity tranche	9,902,984	-	9,902,984	9,598,630
Total debt securities including fixed income securities	**44,483,499**	**(44,749)**	**44,438,750**	**43,972,431**

31.12.2020 (in €'000)	Amortised cost	Unrealised gains	Carrying amount	Nominal amount
Short-term, Medium/ 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**

On 31 December 2021, the amortised cost of the debt securities invested in the Short-term tranche and in the Medium/ Long-term tranche was €34.6 billion (31 December 2020: €37.5 billion), against a carrying amount at fair value of €34.5 billion (31 December 2020: €38.5 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 (see Note 2.8.1), less impairment where needed.

On 31 December 2021, the total carrying amount of the debt securities in the paid-in capital portfolios was €44.4 billion (31 December 2020: €44.3 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 2021, the debt securities including fixed income securities also included investments in money market securities that were not listed on regulated markets with a total carrying value of €149.5 million (31 December 2020: €156.9 million). Their fair values were determined using valuation techniques, as disclosed in Note 2.8.3. 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 2021, debt securities issued by public bodies amounted to €21.7 billion (31 December 2020: €22.3 billion), while debt securities issued by other borrowers amounted to €22.7 billion (31 December 2020: €22.0 billion).

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

As of 1 January 2021, the ESM has changed the accounting policy for the calculation of the costs of debt securities sold from FIFO (first-in-first-out) to AVCO (average cost). This change led to a one-off charge of €3.6 million for the period, which is included in the net profit on financial operations (see Note 21).

The following table presents the details of the paid-in capital portfolio debt securities if the FIFO valuation method would have been consistently applied in 2021 instead of a switch to AVCO.

31.12.2021 (in €'000)	Amortised cost	Unrealised gains	Carrying amount	Nominal amount
Short-term, medium-term and long-term tranche	34,581,052	(45,286)	34,535,766	34,373,801
Hold-to-maturity tranche	9,902,984	-	9,902,984	9,598,630
Total debt securities including fixed income securities	**44,484,036**	**(45,286)**	**44,438,750**	**43,972,431**

8. Intangible assets

The following table shows the movements of intangible assets during 2021:

(in €'000)	Software	Total intangible assets
Historical cost		
1 January 2021 balance	202	202
Additions	33	33
31 December 2021 balance	**235**	**235**
Accumulated amortisation		
1 January 2021 balance	(195)	(195)
Amortisation	(17)	(17)
31 December 2021 balance	**(212)**	**(212)**
Net book value		
31 December 2021 balance	**23**	**23**
31 December 2020 balance	**7**	**7**

9. Tangible assets

The following table shows the movements of tangible assets during 2021:

(in €'000)	Fixtures and fittings	Furniture and office equipment	Total tangible assets
Historical cost			
1 January 2021 balance	10,902	3,004	13,906
Additions	69	597	666
31 December 2021 balance	**10,971**	**3,601**	**14,572**
Accumulated depreciation			
1 January 2021 balance	(6,054)	(2,401)	(8,455)
Depreciation	(1,408)	(340)	(1,748)
31 December 2021 balance	**(7,462)**	**(2,741)**	**(10,203)**
Net book value			
31 December 2021 balance	**3,509**	**860**	**4,369**
31 December 2020 balance	**4,848**	**603**	**5,451**

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)	31.12.2021	31.12.2020
Interest receivable on:		
- Debt securities including fixed-income securities	91,697	104,390
- Loans and advances to euro area member states	346,496	388,049
- Loans and advances to credit institutions	404	328
Amounts charged to the EFSF for administrative services (Notes 20/26)	8,311	9,540
Commitment fee receivable	-	6,590
Prepayments	1,854	884
Prepayments and accrued income on derivatives[1]	528,630	389,163
Total prepayments and accrued income	**977,392**	**898,944**

[1] "Prepayments and accrued income on derivatives" represent the spot revaluation, spread amortisation and accrued income of ongoing derivative transactions (see Note 2.12).

11. Amounts owed to credit institutions

On 31 December 2021, the €1,006.0 million (31 December 2020: €983.1 million) of amounts owed to credit institutions were composed of cash collateral received for the derivatives €55.8 million (31 December 2020: €2.1 million) and repurchase agreements ("repo") €950.2 million (31 December 2020: €980.9 million).

12. Debts evidenced by certificates

The following table discloses the details of debt securities in issue outstanding on 31 December 2021, 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	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	N/A
Long-term Funding	EU000A1U9985[2]	996,500	16/11/2017	18/10/2022	N/A
Long-term Funding	EU000A1U9985[2]	998,550	23/02/2018	18/10/2022	N/A
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%

Type of funding programmes	ISIN code	Nominal amount (in €'000)	Issue date	Maturity date	Coupon
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	N/A
Long-term Funding	EU000A1Z99G8(2)	3,000,000	16/10/2018	17/01/2022	N/A
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	N/A
Long-term Funding	EU000A1Z99M6(2)	2,000,000	11/10/2021	16/12/2024	N/A
Long-term Funding	EU000A1Z99N4	2,000,000	15/03/2021	15/12/2026	N/A
Long-term Funding	EU000A1Z99P9	2,000,000	04/05/2021	15/10/2031	0.010%
Long-term Funding	XS1704649158(4)	2,648,773	31/10/2017	03/11/2022	2.125%
Long-term Funding	XS2051117195(4)	1,765,848	11/09/2019	11/09/2024	1.375%
Long-term Funding	XS2226989015(4)	2,648,773	10/09/2020	10/09/2025	0.375%
Long-term Funding	XS2384361684(4)	1,765,848	09/09/2021	08/09/2023	0.250%
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%
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	EU000A2SB992(1)	1,099,360	14/01/2021	13/01/2022	N/A
Short-term Funding	EU000A3JZP37(1)	1,091,000	11/02/2021	10/02/2022	N/A
Short-term Funding	EU000A3JZP60(1)	1,099,900	11/03/2021	10/03/2022	N/A
Short-term Funding	EU000A3JZP94(1)	1,100,000	15/04/2021	14/04/2022	N/A
Short-term Funding	EU000A3JZQC6(1)	1,099,620	13/05/2021	12/05/2022	N/A
Short-term Funding	EU000A3JZQF9(1)	1,100,000	10/06/2021	16/06/2022	N/A
Short-term Funding	EU000A3JZQJ1(1)	1,099,330	15/07/2021	14/07/2022	N/A
Short-term Funding	EU000A3JZQK9(1)	1,492,100	22/07/2021	20/01/2022	N/A
Short-term Funding	EU000A3JZQM5(1)	1,099,850	12/08/2021	11/08/2022	N/A
Short-term Funding	EU000A3JZQN3(1)	1,499,450	19/08/2021	17/02/2022	N/A
Short-term Funding	EU000A3JZQQ6(1)	1,099,960	16/09/2021	15/09/2022	N/A
Short-term Funding	EU000A3JZQR4(1)	1,500,000	23/09/2021	17/03/2022	N/A
Short-term Funding	EU000A3JZQS2(1)	1,499,740	07/10/2021	06/01/2022	N/A
Short-term Funding	EU000A3JZQT0(1)	1,098,400	14/10/2021	13/10/2022	N/A
Short-term Funding	EU000A3JZQU8(1)	1,499,250	21/10/2021	21/04/2022	N/A
Short-term Funding	EU000A3JZQV6(1)	1,499,580	04/11/2021	03/02/2022	N/A
Short-term Funding	EU000A3JZQW4(1)	1,099,560	11/11/2021	10/11/2022	N/A

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Type of funding programmes	ISIN code	Nominal amount (in €'000)	Issue date	Maturity date	Coupon
Short-term Funding	EU000A3JZQX2[1]	1,499,920	18/11/2021	19/05/2022	N/A
Short-term Funding	EU000A3JZQY0[1]	1,500,000	09/12/2021	03/03/2022	N/A
Total[5]		**116,447,762**			

[1] Zero-coupon bond.
[2] Tap issue.
[3] N-bond with technical ISIN: the ESM issued its first N-bond (Namensschuldverschreibung) 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 debts evidenced by certificates are presented at their amortised cost in balance sheet (see Note 2.14).

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	N/A
Long-term Funding	EU000A1U9985[2]	996,500	16/11/2017	18/10/2022	N/A
Long-term Funding	EU000A1U9985[2]	998,550	23/02/2018	18/10/2022	N/A
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]	1,500,000	14/05/2019	17/01/2022	N/A
Long-term Funding	EU000A1Z99G8[2]	3,000,000	16/10/2018	17/01/2022	N/A
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[1]	3,000,000	17/02/2020	10/02/2023	N/A

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Type of funding programmes	ISIN code	Nominal amount (in €'000)	Issue date	Maturity date	Coupon
Long-term Funding	EU000A1Z99L8	2,000,000	04/03/2020	04/03/2030	0.010%
Long-term Funding	EU000A1Z99M6(1)	2,000,000	26/10/2020	16/12/2024	N/A
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%
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(5)		**117,026,437**			

(1) Zero-coupon bond.
(2) Tap issue.
(3) N-bond with technical ISIN: the ESM issued its first N-bond (Namensschuldverschreibung) 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 debts evidenced by certificates are presented at their amortised cost in balance sheet (see Note 2.14).

The following table shows the movements of the debt securities in issue in 2020 and 2021:

(in €'000)	
1 January 2020 balance	**110,413,094**
Issuance 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**

(in €'000)	
1 January 2021 balance	**117,511,345**
Issuances during the year	54,480,809
Maturities during the year	(55,459,930)
Exchange adjustments	617,510
Premiums/discounts amortisation	(243,183)
31 December 2021 balance	**116,906,551**

Debt securities issued in or after October 2019 were issued under Luxembourgish law as the governing law. Debt securities issued before October 2019 and tapped after this date remain under English law. N-bonds are always issued under German law, and United States dollar-denominated debt securities are always issued under English law.

13. Other liabilities

On 31 December 2021, the other liabilities were composed of suppliers' invoices and staff cost related payables not yet settled, amounting to €9.5 million (31 December 2020: €11.6 million).

14. Accruals and deferred income

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

(in €'000)	31.12.2021	31.12.2020
Interest payable cash and cash equivalents	25,638	25,344
Interest payable on loans to credit institutions	4,011	4,399
Interest payable on debts evidenced by certificates	219,065	284,593
Deferred income on up-front service fee	92,984	138,103
Accruals and deferred income on derivatives[1]	678,409	901,037
Total accruals and deferred income	**1,020,107**	**1,353,476**

[1] "Accruals and deferred income on derivatives" represent the spot revaluation, spread amortisation and accrued expense of ongoing derivative transactions (see Notes 2.17 and 2.6).

As explained in Note 2.4, 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 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

(in €'000)	Subscribed capital	Subscribed, uncalled capital	Subscribed, called capital
1 January 2021	704,798,700	(624,250,300)	80,548,400
Subscription to the authorised capital	-	-	-
Authorised capital calls	-	-	-
31 December 2021	704,798,700	(624,250,300)	80,548,400

On 31 December 2021, 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 completed 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 completed all instalments for the payment of paid-in shares.

On 31 December 2021, the authorised capital was €704.8 billion (31 December 2020: €704.8 billion), divided into 7,047,987 shares (31 December 2020: 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 2020: €624.3 billion) is callable. On 31 December 2021, the total called subscribed capital amounted to €80.5 billion is paid (31 December 2020: €80.5 billion).

ESM Members 31 December 2021	ESM Key (%)	Number of shares	Subscribed capital (in €'000)	Subscribed capital called and paid (in €'000)
Federal Republic of Germany	26.8992	1,895,854	189,585,400	21,666,900
French Republic	20.2003	1,423,716	142,371,600	16,271,040
Italian Republic	17.7506	1,251,062	125,106,200	14,297,850
Kingdom of Spain	11.7953	831,332	83,133,200	9,500,940
Kingdom of the Netherlands	5.6650	399,267	39,926,700	4,563,050
Kingdom of Belgium	3.4454	242,832	24,283,200	2,775,220
Hellenic Republic	2.7910	196,710	19,671,000	2,248,110
Republic of Austria	2.7581	194,388	19,438,800	2,221,580
Portuguese Republic	2.4863	175,236	17,523,600	2,002,700
Republic of Finland	1.7811	125,531	12,553,100	1,434,640
Ireland	1.5777	111,195	11,119,500	1,270,800
Slovak Republic	0.9849	69,418	6,941,800	793,350
Republic of Slovenia	0.4670	32,917	3,291,700	376,190
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	0.2482	17,490	1,749,000	199,890
Republic of Cyprus	0.1945	13,705	1,370,500	156,630
Republic of Estonia	0.1847	13,020	1,302,000	148,800
Malta	0.0898	6,327	632,700	72,310
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 17 June 2021, the Board of Governors decided at their annual general meeting to appropriate the net result of 2020 amounting to €392.9 million to the reserve fund. As a result the outstanding balance of the reserve fund as at 31 December 2021 is €3.0 billion (31 December 2020: €2.6 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)	2021	2020
Interest on loans [(1)]	956,277	1,073,153
Amortisation up-front service fee	45,120	47,408
Commitment fee	-	6,590
Total interest and similar income	**1,001,397**	**1,127,151**

[(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)	2021	2020
Euro area issuers	34,768	45,512
Other EU issuers	4,156	4,240
EU supranational organisations	17,907	12,443
Total European Union	**56,831**	**62,195**
Other non-EU issuers	38,821	34,608
Other supranational organisations	36,632	24,702
Total outside the European Union	**75,453**	**59,310**
Total interest and similar income[1]	**132,284**	**121,505**

[1] As detailed under 2.2, the calculation method for results on debt securities including fixed income securities was changed in 2021 from FIFO to AVCO. For 2020 figures the FIFO method was used. If the FIFO method had been applied throughout 2021, the net interest result would have been €131,783 thousand.

The 2020 figures have been restated to achieve a correct allocation of some countries as other non-EU issuers.

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

On 31 December 2021, the interest payable and similar charges on cash and cash equivalents represent negative interest paid on the balances with central banks and amount to €291.9 million (2020: €309.2 million). The ESM is being charged a negative interest rate of -0.50% per annum. 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 in cash deposits. The compensation has been recorded as an extraordinary income (see 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 during the financial year 2021, the ESM charged the EFSF €33.1 million (2020: €33.1 million), from which €8.3 million (2020: €9.5 million) had yet to be paid on the balance sheet date (see Note 10).

In 2021, the internal tax on salaries retained from staff members amounts to €2.0 million (2020: €1.9 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)	2021	2020
Net realised result of sales of debt securities [1]	154,954	208,289
Net foreign exchange result	(2,323)	3
One-off adjustment for the change of accounting policy	(3,615)	-
Total net result on financial operations	**149,016**	**208,292**

[1] For 2020 figures the FIFO method was used.

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/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.

As of 1 January 2021, the ESM changed the accounting policy for the calculation of the net profit from sales of securities from FIFO to AVCO. The one-off adjustment in the above table represents the impact of the remeasurement of the outstanding securities portfolio from FIFO to AVCO as of 1 January 2021.

For comparative reasons, the following table provides the net result on financial operations if the FIFO method would have been applied throughout 2021:

(in €'000)	2021	2020
Net realised result of sales of debt securities	152,377	208,289
Net foreign exchange result	(2,323)	3
Total net result on financial operations	**150,054**	**208,292**

22. Staff costs

Staff costs are detailed as follows:

(in €'000)	2021	2020
Salaries(1) and allowances	28,900	26,721
Social security costs	1,479	1,203
Pension costs	8,598	8,924
Total staff costs	**38,977**	**36,848**

(1) Of which €2.05 million (31 December 2020: €1.98 million) relate to the ESM Management Board members, including €0.39 million (2020: €0.38 million) to the ESM Managing Director.

The ESM employed 221 persons on 31 December 2021 (203 on 31 December 2020).

In addition to its own employees, the ESM has expenses for employees seconded from other international financial institutions, as well as interim staff, temporary staff hired from external agencies and trainees. The related costs amount to €2.0 million for the 2021 financial year (2020: €1.9 million) and are accounted for as 'Other administrative expenses' (see 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 healthcare 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)	2021	2020
Outsourced services (mainly IT, HR and accounting services)	13,451	11,951
Advisory services	10,492	10,206
Rental and office building related services	5,232	5,557
Other services	3,502	2,657
Treasury related services	3,054	2,582
IT hardware	3,023	2,982
Interim and secondment fees (Note 22)	2,047	1,859
Legal services	969	967
Rating agencies fees	576	453
Total other administrative expenses	**42,346**	**39,214**

24. Extraordinary income

In 2021, the extraordinary income, totaling €216.2 million, was composed of the amounts received from the Federal Republic of Germany, the French Republic, the Italian Republic and the Kingdom of the Netherlands, to compensate the ESM for a part of the negative interest charged on the cash held at their national central banks during 2020. These represent €84.1 million, €62.4 million, €54.5 and €15.2 million respectively.

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.

25. Derivatives

The ESM uses derivatives for risk management purposes only, as described in Note 2.6. 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 hedging 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 also use bond futures and since 2020 short-term 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 2021, the derivative financial instruments had a maximum maturity up to 30 years (31 December 2020: maximum maturity up to 30 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 2021.

(in €'000)	Interest receivable and similar income	Interest payable and similar charges	Net result
Interest result on interest rate swaps(1)	290,863	(692,940)	(402,077)
Interest result on cross-currency asset swaps	128,535	(143,078)	(14,543)
Amortised up-front payments on cross-currency asset swaps	37,617	(6,094)	31,523
Unwind result on cross-currency asset swaps	8,115	(4,794)	3,321
Unwind result on Interest rate swaps	7,166	(4,010)	3,156
Result on futures	14,434	-	14,434
Result on IRBR compensation fee(2)	70,384	(71,286)	(902)
Total	**557,114**	**(922,202)**	**(365,088)**

(1) The net result from the IRS executed to reduce Greece's interest rate risk is passed through to Greece (see Note 3.6.1.1).
(2) One-off compensation fee received or paid by the ESM for the change from EONIA to €STR of the euro short-term benchmark interest rate, applied to cash collateral concluded under the contractual framework of ISDA swap agreements (see Note 2.6.4). The net loss of €902 thousand is mainly due to investment-related activities.

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
Amortised 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 (see Note 3.6.1.1).

The realised part included in 'Interest receivable and similar income' amounts to €557.1 million (31 December 2020: €460.5 million), while for 'Interest payable and similar charges' this represents €922.2 million (31 December 2020: €725.8 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 2021, the total carrying amount of purchased securities issued by shareholders of the ESM was €2.9 billion (31 December 2020: €3.2 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 2021 and 2020, the ESM received payments from France, Germany, Italy, and the Netherlands (in 2021 only) to compensate for the negative interest charged on the cash balances held with their respective national central banks (see Note 24).

On 30 September 2021, €84.1 million was received from Germany, on 6 October 2021, €54.5 was received from Italy, on 7 October 2021, €15.2 million was received from the Netherlands and on 18 October 2021, the ESM received €62.4 million from France. These amounts were recorded as extraordinary income in 2021 (see 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 macroeconomic 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 was amended to reflect the level of activity for cost allocations between the two institutions. The amendment did not result in a material impact in 2021 compared to previous years. In line with the terms of this agreement, the ESM charged the EFSF €33.1 million for the financial year 2021 (31 December 2020: €33.1 million), from which €8.3 million (31 December 2020: €9.5 million) had not yet been paid at balance sheet date (see Note 10). The ESM recognised these amounts as other operating income in the profit and loss account.

27. Audit fee

The total fees paid for 2021 by the ESM to Ernst & Young, Société Anonyme are presented as follows:

(in €'000)	2021	2020
Audit fees	275	275
Audit related fees	92	92
Total Audit fees	**367**	**367**

In 2021 and 2020, the external auditors provided the ESM with audit-related services in relation to with the US-dollar denominated bond issuance.

28. Events after the reporting period

Following Russia's invasion of Ukraine on 24 February 2022, all countries of the European Union and many other countries worldwide, including the US, the United Kingdom and Canada started imposing heavy financial and commercial sanctions on Russia and related companies, financial institutions and wealthy individuals, with the aim of forcing Russia to stop the conflict. Those measures include in particular the freezing of assets held abroad by the Russian central bank and the ban of major Russian banks from the SWIFT system. Beyond the impact on Russia, the sanctions will most likely have an effect on financial markets and economies globally. As a consequence, the ESM's activities may be affected as well. As of today, the concrete magnitude of the effects cannot be reliably assessed. The ESM is analysing direct and indirect implications on its activities and continues to closely monitor the situation to be ready to implement mitigating action, as needed.

There have been no other material post-balance sheet events which could require disclosure or adjustment to the 31 December 2021 financial statements.

05 External auditor's report on the 2021 financial statements

To the Board of Governors of the European Stability Mechanism

Report on the audit of the financial statements

Opinion

We have audited the financial statements of the European Stability Mechanism (the "Entity" or "ESM"), which comprise the balance sheet as at 31 December 2021, 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 2021, 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 judgement, 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 2021, loans and advances to euro area Member States amount to EUR 89.9 billion and relate 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. As at 31 December 2021 no impairment has been recorded by ESM on these outstanding loans.

We considered this as a key audit matter as ESM applies complex judgements 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 judgements to estimate the impairment against specific loans and advances.

Refer to 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 judgements 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 judgement 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 five 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, 28 March 2022

06 Report of the Board of Auditors on the 2021 financial statements

Luxembourg, 28 March 2022

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[6].

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 2021.

The Board of Auditors notes that based on its own work and considering the work of the external auditor, to the best of its judgement, 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 2021.

On behalf of the Board of Auditors

Baudilio Tomé Muguruza
Chairperson

[6] 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 2021 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
BoA	Board of Auditors
BoD	Board of Directors
BoG	Board of Governors
ECB	European Central Bank
EFSF	European Financial Stability Facility
EIB	European Investment Bank
EMU	Economic and Monetary Union
EONIA	Euro Overnight Index Average
ESG	Environmental, Social, and Governance
ESM	European Stability Mechanism
GDP	Gross domestic product
IMF	International Monetary Fund
IT	Information technology
NGEU	Next Generation EU
NGFS	Network of Central Banks and Supervisors for Greening the Financial System
NPL	Non-performing loan
PRI	Principles for Responsible Investment
SRB	Single Resolution Board
SRF	Single Resolution Fund
UN	United Nations
VAT	Value added tax
€STR	Euro short-term rate

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
US	United States
UK	United Kingdom

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