European Stability Mechanism

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Introduction

The European Stability Mechanism (ESM) is a permanent financial assistance crisis mechanism for states belonging to the Eurozone. The ESM is intended to provide stabilisation support for member states that are experiencing or are directly threatened by serious financial problems via a series of financial tools. The Eurozone states belonging to the European Stabilisation Mechanism are Belgium, Estonia, France, Finland, Italy, Ireland, Cyprus, Luxembourg, Malta, Portugal, Austria, Greece, Slovakia, Slovenia and Spain.

At the meeting of the European Council held on the 28th and 29th of October 2010, heads of state and heads of government agreed on the need to implement a permanent crisis mechanism for ensuring the financial stability of the Eurozone as a whole. This mechanism replaces the package of European stabilisation measures introduced in May 2010 providing financial aid to EU member states experiencing difficulties and thus protecting the financial stability of the EU against strong market forces on state bond markets in the Eurozone. This rescue method consists of theEuropean Financial Stabilisation Mechanism (EFSM) and theEuropean Financial Stability Facility (EFSF).

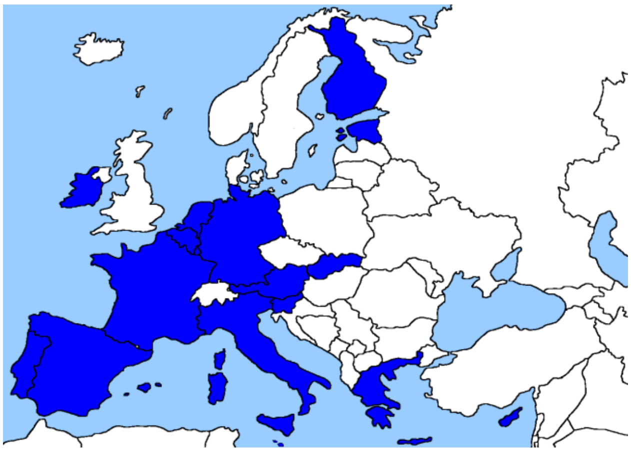
EFSM

The European Financial Stability Mechanism was created by Council Regulation (EU) No. 407/2010 of 11 May 2010 in reaction to the deepening debt crisis in the Eurozone by an agreement among all EU member states, including the Czech Republic. The EFSM authorises the European Commission to mobilise financial resources through issuing of bonds that are guaranteed by the EU budget.

EFSF

The European Financial Stability Facility, or Euroval, was established on May 9, 2010, by a decision by 16 member states of the Eurozone. The EFSF is seated in Luxembourg and serves as an independent financial institution that obtains resources through issuance of obligations and other debt instruments on the capital market, which are guaranteed by Eurozone states based on an agreed mechanism. There are multiple ways to use these resources for temporary financial assistance to those Eurozone states that end up in financial difficulties. The EFSF was conceived as a temporary rescue mechanism, similar to the EFSM, the functioning of which is intended to be taken over by the European Stability Mechanism.

Eurozone states in ESM



On December 16 and 17, 2010, the European Council decided on a change to the Treaty on the Functioning of the EU for implementing a single permanent mechanism for ensuring the financial stability of the Eurozone. A new paragraph 3 was added to Article 136 of the Treaty, which states that member states whose currency is the euro may introduce a stability mechanism that will be activated in situations when necessary to ensure the stability of the Eurozone as a whole and adds that provision of any required financial assistance as part of this mechanism will be subject to strict conditions.

Bodies of ESM (administration and management)

General Director

The General Director of the European Stabilisation Mechanism is appointed by the Board of Governors for a 5-year term. The current and also the first General Director is Klaus Regling. From 2001 to 2008 he served as General Director for Economic and Financial Matters in the European Commission. He has also been the head of the EFSF since its creation in July 2010. The ESM is seated in Luxembourg, like the EFSF.

Board of Governors

The supreme decision body of the ESM is the Board of Governors, and individual members appoint the governor and his/her representatives. Finance ministers from Eurozone states convene Board meetings. They also elect its chairperson. The Board of Governors adopts the most important decisions based on mutual agreement. These include decisions regarding:

- providing financial aid,
- conditions for providing such assistance,
- the credit capacity of the ESM,
- changes in usable instruments.

The Board of Governors adopts other decisions by a qualified majority, which is set as 80% of votes, unless otherwise specified. The European Commissioner for Economic and Monetary Matters and the head of the European Central Bank serve as observers.

Administrative Board

The ESM also has an Administrative Board, to which each Eurozone state appoints one regular member and one substitute member, both of whom have high professional qualifications related to economic and financial matters. This board is presided over by the General Director responsible for everyday running of the ESM. The Commission and the ECB nominate an observer and his/her substitute to the Administrative Board. The Board of Governors assigns specific tasks to the Administrative Board. The Administrative Board adopts decisions by a qualified majority, which is set as 80% of votes, unless otherwise specified.

The weight of the votes in the Board of Governors and the Administrative Board is proportional to the individual member states' shares of the ESM's subscribed capital.

How time passed with ESM

In relation to the report of the working group for administration of economic matters, heads of state and heads of government at the European Council meeting held on from the 28th to the 29th of October 2010, agreed on the need to implement a permanent crisis mechanism for ensuring the financial stability of the Eurozone as a whole. They called on the chairman of the European Council to begin consultations with members of the European Council regarding limitation of adjustments to the Treaty on the Functioning of the European Union, or the Maastricht Treaty, which would need to be carried out for this purpose.

The European Council returned to this matter at its meeting held on the 16th and 17th of December 2010 and agreed that the Treaty should be amended so that Eurozone members could implement the the ESM and agreed that for ensuring the financial stability of the Eurozone, Article 122 paragraph 2 of the Treaty, which is primarily intended for providing financial aid to EU member states affected by natural disasters and other extraordinary events beyond their control, would not be used. In the future, the ESM is expected to replace the temporary EFSF and EFSM, which shall remain valid until June 2013. After June 2013, these mechanisms will continue to function only for administration and settlement of previous loans. EU member states that are not members of the Eurozone will be able to participate in ESM financial operations on a bilateral basis. The European Council decided on the wording of the Council decision that amended Article 136 of the Treaty on the Functioning of the EU, as far as a stability mechanism for member states paying with the euros is concerned.

The decision was formally adopted by the European Council at its meeting held on the 24th and 25th of March 2011 in Brussels. It was adopted unanimously following consultations with the European Parliament, the Commission and the European Central Bank. The member states definitively agreed on the contents of the ESM at the political level already on March 21, 2011.

On July 11, 2011, the finance ministers from all 17 Eurozone countries signed an agreement on establishment of the European Stabilisation Mechanism. Nonetheless, the wording of this agreement was modified to include changes focused on improving the efficiency of the mechanism. The agreement was signed again in Brussels on February 2, 2012.

Germany was the last of the 17 Eurozone states to complete ratification of the ESM. The ratification was delayed in Germany due to a complaint lodged with the Constitutional Court by several legislators. The court gave the green light for establishment of the fund on September 12, but ruled that he government would have to fulfil certain conditions. In accordance with this decision, the government decided that the German Parliament could veto any increase in Germany's contribution to the fun, which is supposed to have available 700 billion euros. Germany's contribution is currently 190 billion euros. On September 26, 2012, Germany eliminated the last obstacle to completing the ratification of the ESM rescue fund for the Eurozone. Chancellor Angela Merkel's government approved a declaration, which ensured the fulfilment of guarantees required by the federal constitutional court.

The ESM agreement became valid on September 27, 2012, and the ESM was ceremoniously launched on October 8, 2012, following its ratification by all 17 Eurozone states.

The Czech government has also commented regarding the establishment of the ESM. After several delays, the Czech Senate approved the creation of the Eurozone rescue fund on April 25, 2012. The measure required only 38 votes for approval in the Senate, but a total of 49 senators across the political spectrum voted in favour of it. The proposal still had to make it through the lower house of parliament, which following several delays approved the creation of the rescue fund on June 5, 2012. A constitutional three-fifths majority of votes from lawmakers was needed in both houses of parliament for approval of the fund, since its creation amends the EU's founding agreements. The adoption of the decision will not have a direct impact on the state budget. The budget burden of the Czech Republic is only expected to be affected later as a result of a potential decision by the Czech Republic to participate in operations performed as part of the ESM. The decision is in accordance with constitutional order and other parts of Czech law, with obligations originating from the Czech Republic's EU membership and with obligations accepted based on other valid agreements and generally recognised principles of international law.

The Czech Republic is neither required nor has been called upon to participate in the ESM. Nonetheless, states outside of the Eurozone may opt to participate in loans provided by the ESM. As far as the impact of the potential enlargement of the Eurozone on the ESM is concerned, involvement in the ESM is not a condition for adopting the euro, and access to the ESM is only possible after joining the Eurozone.

It is expected that when a member state adopts the euro, it will become a member of the ESM with all rights and obligations related thereto. As far as the distribution key for division of contributions to the ESM is concerned, the standard key is based on the member states' share in the paid capital of the ECM. For new Eurozone states (including potentially the Czech Republic if it eventually joins the Eurozone), a more advantageous system has been pushed through, which following a transitional period of 12 years (following establishment of the ESM and following entry to the Eurozone) will compensate states with a GDP per capita of 75% of the EU average.

Capital Structure

The ESM will strive for achievement and sustaining of the highest rating from the main rating agencies. The total amount of subscribed capital of the ESM will be 700 billion euros. Of that amount, 80 billion euros will consist of paid capital, which Eurozone member states will pay and which will be paid in five identical instalments of 16 billion euros each. The first two instalments will be paid within 15 days following commencement of activity, the next two in 2013 and the last 16 billion during the first half of 2014. The ESM will also have at its disposal promised capital paid upon request with guarantees from Eurozone member states in the total amount of 620 billion euros. Member states pledge that during the transitional period from 2013 to 2017, if necessary they will speed up the providing of appropriate instruments in order to maintain a minimum 15% ratio between the paid capital and the unpaid amount of the ESM issuances; however, this situation is not considered likely.

The key for determining the set shares of ESM capital is based on the key for determining shares of the registered capital of the ECB. Member states whose GDP per capita is less than 75% of the EU average will be able to use temporary adjustments for a period of 12 years following entry into the Eurozone. This temporary adjustment will equal three quarters of the difference between the share of GDP and the share of registered capital of the ECB (which practically means a 75% share of GDP and a 25% share of the registered capital of the ECB - meaning from 12.5% of the amount of GDP and from the remaining 12.5% of the number of inhabitants), as follows: Share of ESM = share according to key for registered capital of ECB - 0.75* (share according to key for registered capital of ECB - share of GDP). The compensation via adjustments down for involved countries is spread among all other countries based on their share of the base of the key for the European Central Bank's capital.

Through ratification of the agreement on the establishment of the ESM, member states have legally committed themselves to pay their shares of the total amount of subscribed capital. The Board of Governors decides about the adjustment of the total amount of subscribed capital and about requests for payment of the capital by mutual agreement, except in the following special situations:

1. If as a result of absorption of losses, the volume of paid capital is reduced, the Administrative Board may decided by a simple majority to restore its original amount via a request for payment of capital.
2. A ready guarantee mechanism will be implemented, which will enable ESM shareholders to call automatically for payment of capital, if this is necessary in order to prevent a shortage of resources for payments to creditors.

Capital Contribution for ESM

Country	bln. €	in %	Country	bln. €	in %
Germany	190.02	27.15	Finland	12.58	1.80
France	142.70	20.39	Ireland	11.14	1.59
Italy	125.39	17.91	Slovakia	5.77	0.82
Spain	83.32	11.90	Slovenia	2.99	0.43
Netherlands	40.02	5.72	Luxembourg	1.75	0.25
Belgium	24.34	3.48	Cyprus	1.37	0.20
Greece	19.71	2.82	Estonia	1.30	0.19
Austria	19.48	2.78	Malta	0.51	0.07
Portugal	17.56	2.51	**Total**	**700.00**	**100.00**

Source: European Stability Mechanism

In any case, however, individual shareholders guarantee only up to the amounts of their shares of the subscribed capital. Any share of the subscribed capital from a member state that joins the ESM after July 2013 will be determined based on the same conditions that were applied for original shares. The Board of Governors shall decide by a mutual agreement regarding the practical consequences for the total amount of subscribed capital and its division among member states.

During adoption of this decision, the vote of a member state whose failure was caused by a loss that needs to be covered shall not be taken into consideration. As a result of entry into the Eurozone, a member state will become a member of the ESM with all of the rights and obligations related thereto. Until the European Stability Mechanism is activate and until its actual loan capacity falls to below 500 billion euros, the returns from investments related to the paid ESM capital will be returned to member states following deduction of operation costs.

Following the first activation of the ESM, the returns from ESM capital investments and from financial assistance activities will be kept by the ESM. However, if the volume of paid capital exceeds the level necessary for sustaining the ESM's loan capacity, the Administrative Board may decide by a simple majority to divide dividends among Eurozone member states based on the share key.

Access to financial assistance from the ESM will be provided based on strict policy conditions within a healthy macroeconomic programme and based on a thorough analysis of the sustainability of public debt, which the Commission will carry out together with the IMF and in cooperation with the ECB. The accepted member state will be required to ensure involvement of the private sector in appropriate manner, depending on the specific situation and a method fully compatible with IMF practices.

Total Loan Capacity

The actual loan capacity of the ESM will be 500 billion euros. The reasonableness of the loan capacity will be examined regularly and at least once every five years. The ESM will attempt to add to its loan capacity by involving the IMF in financial operations; member states outside of the Eurozone may also opt to participate if they wish. In view of the 200 billion euros financed from the EFSF, the combined loan capacity of the EFSF and ESM is 700 billion euros.

Financing Functioning and Strategy

The ESM's responsibility will be to mobilise sources of financing and under strict conditions to provide financial aid to Eurozone states that experience serious problems with financing or are at risk of experiencing such problems, so that the financial stability of the Eurozone as a whole is ensured.

The ESM sources of financing will be shareholders' paid capital and loans that the ESM will arrange in its own name on financial markets.

Paid capital

Capital paid by member states will serve for investing into secure, highly evaluated and liquid state bonds. It will not be intended for purchasing of state bonds on the primary or secondary market.

ESM Bonds

The ESM has the the authority to borrow from banks and other institutions in order to achieve its goals on capital markets. Like in the case of the EFSF, use is expected of services from the German Debt Management Office (DMO) as the issuing agent for placing ESM debt instruments on the financial market. The ESM will serve as the issuer of all debt instruments that fall in the category SSA (Sovereign, Supranational, Agency).

The ESM is authorised to issue debt instruments on the financial market (with maturity within one year) and on the capital market, where issuing of bonds with a maturity period of from 1 to 30 years is expected. The ESM may hold its own bonds to a limited extent, use them for sale on secondary markets or use them as collateral when securing operations on the financial market. As an addition to issuance of bonds, the ESM may issue bills of exchange.

Like in the case of the EFSF, it is expected that the investors into bonds issued by the ESM will be mainly banks, retirement funds, central banks, administrative state and sovereign funds, asset managers, insurers and commercial banks.

From the beginning, the ESM will focus on issuing of bonds in euros for the entire yield curve and thus will set a new benchmark. The ESM can then diversify its financing strategy by focusing on other currencies. These operations in foreign currencies will be secured with the help of swap derivative instruments.

Eurozone states will pay financial sanctions to the ESM imposed within the stability and growth pact and in accordance with procedures during macroeconomic imbalances. These sanctions will be part of the paid capital. The ESM will apply an appropriate financing strategy in order to ensure access to a wide range of resources and so that it can provide member states with financial aid packages regardless of the situation on the market. All related risks will be limited by reasonable management of assets and liabilities.

If it is absolutely necessary to ensure the stability of the Eurozone as a whole, the ESM, in accordance with the amendment to Article 136 of the Treaty, will provide financial aid subject to strict conditions within the healthy macroeconomic programme, which will be reasonable in relation to the seriousness of the imbalances in the particular member state. This aid will take the form of loans. However, within the healthy macroeconomic programme with strict conditions and with approval from the Board of Governors based on a mutual agreement, the ESM may exceptionally intervene on the primary bond markets.

ESM support instruments:

1. Stabilization support (Sovereign, Supranational, Agency - SSA)

The ESM may provide short-term or mid-term stabilization aid to Eurozone states that experience serious problems with financing. A condition for access to the aid will be a healthy macroeconomic programme with corresponding reasonableness of policies, which shall be reasonable in relation to imbalances in the accepting member state. The duration of the programme and the maturity of loans will depend on the nature of the imbalances and the member state's outlooks for restoring access to financial markets during the period within which the ESM resources are available.

2. Bank recapitalization

The Board of Governors may decide to provide financial aid via loans for an ESM member intended for the specific purpose of bank recapitalisation in the particular ESM member state. The financial conditions for aid for recapitalisation will be specified in the agreement on financial aid instruments, which the General Director will sign.

3. Precautionary financial assistance

The ESM may provide precautionary financial assistance in the form of credit lines to member states that have problems with refinancing on financial markets, but still have not lost the trust of investors. The financial conditions for aid for precautionary financial assistance from the ESM will be specified in the agreement on financial aid instruments, which the General Director will sign.

4. Primary Market Support Facility

With the aim of maximising the cost effectiveness of aid, the ESM may purchase bonds of a member state that has serious problems with financing on the primary market, directly in auctions conducted by the member state's finance ministry. The conditions and means of purchasing bonds will be set in a decision regarding conditions for financial aid, which the General Director will sign. The Board of Governors may examine the means that the ESM has at its disposal and may decide to make changes accordingly.

5. Secondary Market Support Facility

Besides operations on the primary market, the ESM may also actively intervene the inter-bank market, also known as the secondary market. Decisions regarding intervention in the secondary market will be adopted based on an analysis by the ECB. The financial conditions under which operations on the secondary market will be performed will be set in an agreement on a financial support means, which the General Director will sign. The Administrative Board shall adopt detailed conditions related to the method of implementing support facilities on the secondary market.

When providing financial assistance, the ESM will work very closely with the IMF. In all cases, an attempt will be made to get the IMF actively involved, both at the technical and financial levels. The Commission and the IMF jointly and in cooperation with the ECB will perform a debt sustainability analysis. The Commission and the IMF shall also jointly and in cooperation with the ECB negotiate the terms of policies to which aid from the ESM and IMF will be bound. However, any involvement of the IMF will comply with its mandate under the articles of the agreement and with relevant IMF decisions and policies.

Financial aid from the ESM will always be activated based on a request issued by a member state to the other member states of the Eurozone. The Euro Group shall inform the Council about the submission of a request for activation of support. Following receipt of the request, the Board of Governors will ask the Commission to evaluate in cooperation with the ECB the existence of risks for the financial stability of the Eurozone as a whole and in cooperation with the IMF and the ECB to prepare a detailed analysis of the involved member state's public debt sustainability.

Seniority of ESM loans

Loans provided by the ESM will also have seniority status, meaning that the ESM similarly to the IMF will have the status of a priority creditor in the event of insolvency of the state or bank that owes the debt. The IMF's status as a priority creditor having priority over the ESM's status as a priority creditor was also approved.

If any dispute arises between a Eurozone member state and the ESM in relation to the interpretation and application of the agreement on establishment of the ESM, the Board of Governors shall decide regarding the dispute. If the involved member state challenges that decision, the dispute will be referred to the European Court Tribunal. As far as the relationship between the ESM and third parties is concerned, the usable governing law and court jurisdiction will be adjusted in legal and contractual documentation, which will subsequently be used between the ESM and involved third parties.

Participation of EU states outside of the Eurozone

EU member states that are not members of the Eurozone may participate in operations for providing financial assistance to Eurozone members parallel with the ESM on an optional basis. If member states outside of the Eurozone participate in these operations, they may be represented at relevant ESM board meetings, at which decisions will be adopted regarding providing and monitoring aid. However, they will have timely access to all relevant information and will be consulted accordingly. Eurozone states shall support the equal creditor status of the ESM and other member states that provide loans parallel with the ESM. The Board of Governors may decide to provide financial aid via loans for an ESM member intended for the specific purpose of bank recapitalisation in the particular ESM member state. The financial conditions for aid for recapitalisation will be specified in the agreement on financial aid instruments, which the General Director will sign.