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Reform of the European Stability Mechanism (ESM)

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On 4 December 2018, the Eurogroup agreed on a reform of the European Stability Mechanism (ESM). In the coming months, these political agreements will be further substantiated and formally implemented through amendments to the ESM Treaty and the ESM Guidelines. In the run-up, we present and evaluate the Eurogroup's political agreements in this cep**Adhoc**.

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- The condition that the Euro State must not have caused a negative shock "beyond its own control" must be a mandatory criterion for access to the ESM credit line. This is all to more important as the decisions of the Eurogroup make it unlikely that ESM credit lines will be subject to economic policy conditionality.
- The forthcoming amendments to the ESM Treaty and the ESM Credit Line Guideline must continue to provide for decision-making procedures in which Germany cannot be outvoted.

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- The planned "single limb collective action clauses" are a necessary prerequisite for a future participation of creditors ("bail-in") also for government bonds. It remains completely open, however, who will decide on the activation of such clauses and in which procedure this will happen.

ESM as "common backstop" for bank resolution

- The ESM backstop, allowing for the ESM to grant credit to the Single Resolution Fund (SRF), alleviates the consequences of the close links between banks and states, but it does not cure the cause of this links. The Euro States must reduce their own insolvency risk by obliging banks to back sovereign exposure with equity.
- Given a bank resolution, the ESM backstop should only be activated after the Euro State concerned has taken on a minimum share of the resolution costs.
- By deleting the existing ESM instrument of direct bank recapitalisation, the ESM backstop does not lead to higher risks for the federal budget, at least given the volume of the backstop currently envisaged. Germany cannot be outvoted in ESM decisions regarding activating the backstop and increasing its volume.
- For political reasons, it is unlikely that the ESM backstop will be introduced before 2024. Without a (very unlikely) unanimous amendment to the Agreement (IGA) on the transfer and mutualisation of contributions to the SRF, until 2024, only the banks of the Euro State affected by a bank resolution are liable for the repayment of ESM loans to the SRF.
- The effects of the condition that fiscal neutrality must be given in the medium term cannot be accurately assessed yet. Given strict application, the amount of ESM loans to the SRF, which is still fiscally neutral in the medium term, will be limited.
- It is necessary to clarify the envisaged possibility for the ESM to provide liquidity to banks in liquidation. On the one hand, it is important to minimise the resulting default risks for the ESM. On the other hand, any conditions attached by the ESM to such liquidity provision may interfere with the powers of the Single Resolution Board (SRB).

1 Introduction

On 4 December, the Eurogroup agreed on a reform of the European Stability Mechanism (ESM). The decisions are less far-reaching than the EU Commission has been striving for. The Commission had proposed in December 2017 that the intergovernmental ESM should be anchored in EU law as the European Monetary Fund (EMF) and that majority decisions should increasingly be introduced (cf. cep**PolicyBrief** 13/2018).

The Eurogroup has set other accents. It agreed on amendments to the conditions under which euro area Member States can benefit from the ESM's "precautionary credit lines" (see cep**PolicyBrief** 12/2012) and added provisions on debt sustainability. It also agreed that the ESM will in future serve as a common fiscal backstop for the Single Resolution Fund (SRF) (cf. cep**Input** 04|2017).

In the coming months, the political agreements of the Eurogroup will be further substantiated and formally implemented through amendments to the ESM Treaty and the ESM Guidelines. Drafts for these concrete changes still need to be developed. Prior to this, the political agreements will be presented and evaluated in this cepAdhoc.[1]

2 ESM credit lines

In addition to general loans to Euro States, loans to Euro States to recapitalise financial institutions, purchases of government bonds on primary and secondary markets and direct recapitalisation of banks, the ESM can already approve "precautionary financial assistance" in the form of credit lines.[2] The credit lines are drawn in the form of ESM loans or primary market purchases by the ESM. They shall be valid for one year and may be extended twice for six months at a time. To date, the instrument has not been used by any Euro country.

2.1 Eligibility criteria

2.1.1 Existing rules

As for all ESM assistance, ESM credit lines are only admissible if there is a threat to the financial stability of the euro area as a whole and its Member States. An ESM Guideline on Precautionary Financial Assistance[3], while clarifying some of the conditions for the use of the credit lines, leaves questions unanswered. ESM credit lines may only be granted to Euro States whose economic and financial situation is "fundamentally sound"[4]. To this end, the EU Commission, in cooperation with the European Central Bank, must carry out a "global assessment" based on six criteria:

(1) Compliance with the Stability and Growth Pact: A Euro State subject to an excessive deficit procedure can only have access to a credit line if it complies with the decisions and recommendations of the Council on the correction of its excessive deficit.

[1] Sources: “Terms of Reference of the common backstop to the Single Resolution Fund” and “Term sheet on the European Stability Mechanism Reform” (both dated 4 Dezember 2018).

[2] Art. 14-18 ESM Treaty. Direct bank recapitalisation by the ESM was - controversially - not introduced by an ESM Treaty amendment, but by the Board of Governors on the basis of Art. 19 of the ESM Treaty.

[3] ESM Guideline of 9 October 2012, https://www.esm.europa.eu/sites/default/files/esm_guideline_on_precautionary_financial_assistance.pdf. There is no official German translation of the guideline.

[4] „where the economic and financial situation is still fundamentally sound“ (Art. 2 para. 2, ESM-guideline).

(2) A sustainable general government debt.
(3) Avoidance of excessive imbalances: A Euro State subject to an excessive imbalance procedure (EIP) can only have access to a credit line if it remains committed to correct the imbalance identified by the Council.
(4) A track record of access to international capital markets on reasonable terms.
(5) A sustainable external position.
(6) The absence of solvency problems at banks that pose a systemic threat to the stability of the Eurozone banking system.

However, not only is it unclear whether all the criteria must be fulfilled simultaneously.[5] Also, the exact meaning of some criteria is also unclear due to the vague wording of the ESM Guideline.

2.1.2 New rules agreed upon by the Eurogroup

As in the past, the ESM credit lines should only be available to Euro States whose economic and financial situation is fundamentally sound[6]. It is added that Euro States wishing to make use of the credit line "could be affected by an adverse shock beyond their control".[7]

The eligibility criteria for the ESM credit line should become more transparent and predictable. In the future, a "quantitative and qualitative" examination will be carried out to determine whether the economic and financial situation of a Euro State is sound.

The existing six criteria will be replaced by the following quantitative and qualitative criteria, which "as a rule" must be fulfilled in the last two years prior to applying for the credit line. The quantitative criteria are:

(1) Government debt amounted to less than 60% of GDP or fell by 5% per annum.
(2) The deficit was less than 3% of GDP.
(3) The "minimum benchmark" was respected, i.e. the value of the structural balance that ensures that the 3% limit is not breached in an economic downturn even without fiscal countermeasures.

The qualitative criteria are:

(1) The state has no excessive imbalances.
(2) The government is not subject to an excessive deficit procedure.
(3) The general government debt is sustainable.

2.2 Conditionality

2.2.1 Existing rules

It is currently unclear whether ESM credit lines can or must be subject to conditionality.

In principle, the ESM Treaty provides that any ESM assistance shall be subject to "strict" but "appropriate conditionality"[8]. This conditionality is set out in a Memorandum of Understanding.[9] However, this conditionality may "range from a macroeconomic adjustment programme to the continuous respect of pre-

[5] „A global assessment shall be made (…) using as a basis the following criteria“ (Art. 2 para. 2).
[6] „Sound economic fundamentals“ (Term Sheet on ESM Reform, 4.12.2018)
[7] „which could be affected by an adverse shock beyond their control“, (Term Sheet on ESM Reform, 4.12.2018)
[8] Art. 3 ESM Treaty.
[9] Art. 13 para. 3 ESM Treaty.

established eligibility conditions".[10]

The ESM Treaty also prescribes "conditionality" for credit lines, which "shall be detailed" in a Memorandum of Understanding (MoU) to be concluded with the Euro State concerned[11]. The ESM guideline for the credit lines stipulates that the MoU defines the "policy conditions". Whether this merely requires that the eligibility criteria be fulfilled also after the credit line has been granted[12], or whether additional economic policy conditions can or even must be imposed, is not clearly regulated.

2.2.2 New rules agreed upon by the Eurogroup

In the absence of agreements to the contrary, the ESM Treaty should continue to impose "appropriate conditionality" on all ESM aid, including credit lines.

What is new, however, is that in future the Euro State will "formally" commit in a Letter of Intent ("LoI") to fulfil the eligibility criteria even after the credit line has been granted. Although there is no concrete statement by the Eurogroup, it can be assumed that the Letter of Intent replaces the Memorandum of Understanding.

The Letter of Intent sets out the main elements of the economic policy strategy of the Euro State seeking ESM assistance. As in the past, it is not clear whether economic policy conditions can or even must be imposed in addition to the continuous fulfilment of the eligibility criteria. However, the LoI is a unilateral declaration by the Euro State seeking assistance. The MoU also had to be signed by the EU Commission (on behalf of the ESM).[13]

2.3 Monitoring

2.3.1 Existing rules

Once a Euro State has actually drawn an ESM credit line, the Commission will monitor this Euro State. The latter shall "in consultation and cooperation" with the Commission take "measures" to eliminate the actual or potential sources of difficulties[14]. The Commission shall examine the need for further action on a quarterly basis.

2.3.2 New rules agreed upon by the Eurogroup

The EU Commission and the ESM (the exact division of labour is still to be decided) will check at least every six months whether the Euro State continues to fulfil the eligibility criteria. In the absence of any agreements to the contrary, it can be assumed that this review will only take place, as before, after the Euro country has actually drawn the already approved credit line. No explicit mention is made of the other "measures" that the Euro State has to take at present in "consultation and cooperation" with the Commission.

[10] Art. 12 para. 1 ESM Treaty.
[11] Art. 14 para. 2 ESM Treaty.
[12] „The benificiary ESM Member shall ensure a continuous respect of the elibility criteria after the PCCL is granted“ (Art. 2 para. 3 ESM-guideline).
[13] Art. 13 para. 4 ESM Treaty
[14] „… adopt measures aimed at addressing the sources or potential sources of difficulties“ (Art. 5 para. 1 ESM-guideline)

2.4 Sanctions

2.4.1 Existing rules

If the Euro State deviates from the "policy conditions" – continued compliance with the eligibility criteria, possibly further economic policy conditions or the additional "measures" identified "in consultation and co-operation" with the Commission – or if "those commitments" are obviously no longer adequate to resolve the risk of financial disturbance, the ESM Board of Governors "may" close the credit line.[15]

When the credit line is closed, the Euro country is expected to apply for a regular ESM loan with a comprehensive macroeconomic adjustment programme.

2.4.2 New rules agreed upon by the Eurogroup

In the event of non-compliance with the eligibility criteria, the credit line will be closed. Whether this will require an explicit decision by the ESM Board of Governors is unclear at the moment. If the credit line has already been drawn, the lending rate for the Euro State concerned will initially increase by 50 basis points. The credit line will not be closed if the non-compliance with the eligibility criteria is due to events which, in the opinion of the ESM Board of Directors, are 'outside the control' of the respective government.

2.5 Assessment

2.5.1 Fundamental Assessment

ESM credit lines can be useful for Euro States that are re-entering the capital market after the expiry of ESM programmes. In the run-up to the reform that has now been agreed upon, however, the main issue has been to create an instrument that can help Euro States affected by an asymmetric, negative shock that is "outside the control" of the respective government.

These cases seem very hypothetical. If they do occur, however, they can also be dealt with by regular ESM loans. The eligibility criteria – which is open to interpretation – that the Euro State itself has not caused the shock, could be taken into account in a regular ESM loan by applying relatively soft economic policy conditionality.

There is therefore no convincing reason to revise the rules for ESM credit lines.

2.5.2 Detailed Assessment

The new ESM credit lines will be introduced by amendments to the ESM Treaty and by a revision of the ESM Credit Line Guideline. Drafts for these concrete changes are not yet available. Subject to subsequent substantiation, the amendments adopted politically on 4 December will be assessed.

<u>**Eligibility criteria:**</u> **The new eligibility criteria** provide a mixed picture. If they are strictly applied, they **are much stricter than the existing ones. Only a few, very solid Euro States meet them.** Italy, for example, will not be able to meet the quantitative criteria in the next two years.
What is new is the consideration that Euro States wishing to make use of the credit line *"could"* be affected by a negative shock beyond their control. It remains to be seen whether this will have the status of an eligi-

[15] „The Board of Governors may decide to close the credit line“ (Art. 7 para. 2 ESM-guideline).

bility criterion for the ESM credit lines and how it can be assessed in practice. However, the criterion is indispensable because it can reduce the number of Euro States that can apply for the credit line and thus prevent Euro States from increasingly applying for ESM credit lines instead of general ESM loans in order to circumvent hard conditionality. **For the application for an ESM credit line, the negative shock, which lies outside the control of the Euro State, should** therefore **be a mandatory eligibility criterion in the ESM Treaty.** Euro states applying for a credit line "should" (not: "could") be affected by a shock.
It is also **problematic that the eligibility criteria should only apply "as a rule".** For a further assessment, the exact amendments to the ESM Treaty and to the ESM credit line Guideline must be awaited. However, if – as before - the ESM-bodies decide unanimously on the approval of a credit line, Germany could – if it so wishes - enforce a consistent interpretation of the eligibility criteria.

Conditionality: In the future as well, it will not be clear whether economic policy conditions can or must be imposed on ESM credit lines in addition to continuous fulfilment of the eligibility criteria. **However, the fact that the Letter of Intent (LoI) will replace the Memorandum of Understanding (MoU) makes it more difficult to impose economic policy conditions that go beyond the continuous fulfilment of the eligibility criteria**. The LoI is a unilateral declaration by the Euro State concerned. In contrast to the MoU, negotiations between the Commission or the ESM on the one hand and the Euro State on the other hand are not explicitly provided for in the Eurogroup agreement. However, it is conceivable that the application for an ESM credit line will not receive the necessary unanimous approval in the ESM Board of Governors as long as the LoI does not meet the expectations of all ESM states. To replace the MoU with the LoI, the ESM Treaty must be amended.

Monitoring: As a result of the establishment of a unilateral LoI, it is unlikely that ESM credit lines will be subject to economic policy conditions. The fact that the Eurogroup agreement does no longer mention that the Commission and ESM will monitor the implementation of further 'measures' also suggests this. Regarding the precise division of labour between the ESM and the Commission, the ESM should take the lead, as it is less susceptible to political interference.

Sanctions: The **sanctions for non-compliance with the eligibility criteria and any other policy conditions will become stricter**. The credit line "must" (currently: "may") be closed, unless the non-compliance lies outside the control of the respective government. Although this exception leaves much room for interpretation, its application may well require a decision by the ESM Board of Directors. In the absence of information on the Eurogroup’s intention to amend the ESM Treaty in this regard, Germany will retain a right of veto here.

2.5.3 Summary

There is no convincing reason to revise the rules for ESM credit lines. Only very few Euro States meet the new, stricter criteria for applying for an ESM credit line. These countries are unlikely to need the credit line. Due to the planned exemptions for the eligibility criteria, however, there is a danger that less solid Euro States will also be able to request an ESM credit line and thus circumvent a regular ESM loan including strict conditionality. The condition that the Euro State must not have caused the negative shock itself must be clearly included as a mandatory eligibility criterion for the ESM credit line. This is important because the Eurogroup's political agreement of 4 December makes it unlikely that ESM credit lines will be subject to economic policy conditions.

For these reasons, the forthcoming amendments to the ESM Treaty and the ESM Credit Line Guideline should continue to provide for decision-making procedures in which Germany cannot be outvoted.

3 Participation of creditors in insolvencies of Euro States

3.1 Existing rules

Until now, the ESM Treaty has stipulated that all government bonds of Euro States must contain a standardised debt-rescheduling clause ("collective action clause") since 2013.[16]

3.2 New rules agreed upon by the Eurogroup

Financial support from the ESM will continue to be granted only to countries whose debt is sustainable and whose ability to repay the support has been confirmed by the Commission, the ECB and the ESM[17]. The political agreement of the Eurogroup implies that ESM assistance to a Euro State whose debt is unsustainable will only be possible after this debt has been made sustainable. “Single limb collective action clauses”, which the Euro States "intend" to introduce by 2022, should serve as an instrument for this purpose. They also want to include this intention in the ESM Treaty. The aim of these clauses is to make it easier to decide on debt relief or a maturity extension for government bonds of all maturities. At the request of the Euro State concerned, the ESM is to mediate between the Eurozone and private creditors.

3.3 Assessment

According to the ESM Treaty, all government bonds must contain collective action clauses since 2013. **The extension to "single limb collective action clauses",** which cover all bonds – and not only individual issues – of a Euro State, **is a necessary prerequisite for a future participation of creditors ("bail-in") also for government bonds.**[18]

It remains completely **open**, however, **who will decide on the activation of such clauses and in which procedure this will happen.** There is no indication of political agreement on automatically extending the maturity of sovereign debt when ESM assistance is granted. The statement that the ESM may only conduct debt rescheduling negotiations at the request of the state concerned raises fears that the activation of collective action clauses will remain the absolute exception. Several Euro States are opposed to bailing-in creditors of government bonds because they fear higher financing costs.

4 ESM as "common backstop" for the banking union

4.1 Current rules

In the euro area, part of the costs incurred in the resolution of banks that are not capable of being restructured are borne by the Single Resolution Fund (SRF). All banks in the euro area will have to make financial contributions to this fund, which will be paid into national compartments until 2024. These compartments will gradually be mutualised. By mid-2018, the SRF had 25 billion Euro at its disposal[19]. By 2024, the SRF is expected to reach its target level of approximately 61 billion euros[20]. The SRF funds may only be used for

[16] Art. 12 para. 3 ESM Treaty
[17] Term Sheet on ESM Reform, 4.12.2018.
[18] With the existing CACs, it is comparatively easy to acquire a blocking minority against the triggering of the CAC by purchasing the bonds of a specific issue in a targeted manner.
[19] https://srb.europa.eu/en/node/596.
[20] Art. 69 SRM Regulation (EU) No. 806/2014.

bank resolution if private creditors participate in the loss with at least 8% ("bail-in")[21]. If the SRF funds are insufficient, extraordinary ex-post contributions by the banks must first be raised.[22] Only after this has been done, the "Backstop" takes effect[23]. This backstop currently consists of national credit lines from the Euro States to the SRF, each amounting to the contributions made by the banks of these respective states to the SRF's resources. Only the national credit line of the State in whose territory a bank is being put in resolution will be used.

4.2 New rules agreed upon by the Eurogroup

In future, a joint ESM credit line – instead of the existing national credit lines – is to serve as a backstop for the SRF.[24] The following rules shall apply:

(1) The credit line will be established by 2024 at the latest. A decision on an earlier introduction – amounting up to the volume of the SRF funds then available – will be taken in 2020. It will be examined whether the Euro States have sufficiently reduced the risks in their banking sectors. Non-performing loans (NPLs) are particularly relevant for this. They may not exceed 5% gross (i.e. before deduction of provisions) and 2.5% net (after deduction of provisions) of all loans.[25] An early introduction of the ESM backstop only for individual Euro States is excluded. It is possible, however, that the backstop will be introduced for the entire Eurozone from 2020, but on a limited scale. In case of an early establishment of the backstop, the aim is to amend the intergovernmental agreement (IGA) on the SRF.

(2) The backstop must be activated in each and every individual case. The SRF must request its activation and the ESM Board of Directors[26] must decide to do so unanimously. In principle, a decision should be taken within 12 hours – in complex cases: 24 hours – after the request for activation of the backstop has been made. The ESM States "endeavour" to establish an emergency procedure in which only 85% of the votes are required for activation. The emergency procedure should also respect the necessity for some national parliaments to agree with the activation. [27]

(3) For the activation of the ESM backstop, the following prerequisites apply in particular:
- The backstop is the "last resort".
- The principle of fiscal neutrality – i.e. the remaining banks must be in a position to repay the ESM loan via the SRF – will be respected "in the medium term". This will be examined by the Commission and the ESM, although the concrete division of labour will not be defined until 2019.
- The provisions of the Single Resolution Mechanism (SRM) Regulation and the Bank Recovery and Resolution Directive (BRRD) are complied with.
- The necessary resources are available to the ESM.
- Any other ESM assistance to the SRF is not in default.

(4) The ESM backstop replaces the existing ESM instrument of direct bank recapitalisation, for which up to EUR 60 billion could be used. The volume of the ESM backstop will initially be identical to the SRF

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[21] Art. 27 para. 7 SRM Regulation (EU) No. 806/2014.

[22] Art. 71 SRM Regulation (EU) No. 806/2014 and Art. 5 para. 1 lit. d Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund. Until the national chambers are fully mutualised in 2024, only banks from states affected by bank liquidation will have to pay extraordinary subsequent contributions. After 2024, all euro area banks will be used.

[23] Art. 5 para. 1 lit. e Agreement on the transfer and mutualisitation of contributions to the Single Resolution Fund.

[24] See statement of the Eurogroup dated 18 December 2013, which provided for joint final collateralisation by 2024 at the latest.

[25] The wording of the Eurogroup leaves room for interpretation. Thus, a declining volume of NPL, which still surpasses these limits, may be found to be acceptable.

[26] The ESM Board of Directors consists of representatives of the finance ministries of the Euro States "with great expertise”. Voting power is based on the share of each Euro State in the ESM-capital (see cep**PolicyBrief** 12/2012).

[27] In Finland, Estonia, Austria and the Netherlands, parliamentary participation rights are comparable to those of the Bundestag.

target level (1% of covered deposits with banks in the Eurozone, currently around 61 billion euros). The ESM Board of Directors may amend the volume. However, the Board of Governors of the ESM also sets a higher nominal upper limit for the backstop. If the target level of the SRF increases – e.g. due to rising bank deposits – the ESM Board of Directors can adjust the volume of the backstop up to the nominal upper limit.

(5) The SRF – and thus the remaining banks in the Eurozone – must repay backstop loans within three years. The interest cost on the loans amounts to the ESM financing rate plus a premium of 35 basis points. The ESM Board of Directors may extend the term by two years, increasing the interest costs by a further 15 basis points.

(6) The ESM backstop can be used to provide liquidity to banks that are in resolution or are returning to the market after resolution by the SRM. Further safeguards will be discussed in 2019.

(7) The ESM is a preferential creditor of the SRF.

4.3 Assessment

4.3.1 General Assessment

The ESM backstop for the SRF **alleviates the consequences of the close links between banks and states, but not their causes.** If **the Euro States** really want to prevent a Euro State's solvency from depending on the solvency of its banks, they **must oblige the banks to back government bonds with equity**. That was however not decided. Instead, there is an intention that Euro States with unstainable debts will in future only receive ESM assistance after their creditors have been bailed-in (cf. single limb in Section 3). However, the practical possibility of such a bail-in is limited without consistent capital backing of government bonds by banks. As banks hold a large part of government debt, creditor participation by these banks, without them having to build up equity on sovereign exposures well in advance would jeopardise the stability of the financial market.

The ESM backstop for the SRF reduces the risk that the resolution of a bank could jeopardise the creditworthiness of a Euro State. However, a number of instruments for financial assistance have already been set up to deal with this problem. Examples include general ESM loans to the Euro State – subject to economic policy conditionality – or earmarked ESM loans to Euro States for bank recapitalisation. These instruments reduce the need and scope for ESM involvement as a backstop for the SRF. As main disadvantage, the existing instruments increase the debt level of the affected Euro State and thus further jeopardise its creditworthiness. The existing backstop for the SRF leads to the same problem, because the Euro State on whose territory the bank to be put in resolution has to provide money. The ESM backstop for the SRF, on the other hand, does not lead to this because the Eurozone grants the loans jointly.

The ESM backstop can therefore increase the financial market stability of the Eurozone. However, it leads to two risks elsewhere:

Firstly, **the ESM backstop** can lower the barriers to use the SRF and hence lead to softer resolution measures. This is problematic. In order to avoid shifting settlement costs and -risks to other banks (via the SRF) and taxpayers (via the ESM), the ESM **must ensure that the SRF and the Commission strictly apply the bail-in and State aid rules.**

Second, despite uniform banking supervision by the ECB, the euro area countries still have opportunities to influence the size and risk sensitivity of the domestic financial sector. For this reason, **the ESM backstop should be activated only after the Euro State concerned has taken on a minimum share of the settlement costs**. In the case of direct bank recapitalisation by the ESM (which is now to be abolished), the Member

State concerned had to contribute 10 % of the ESM contribution. The own contribution of the Euro State concerned is also important because the Euro State may refuse to apply for a general ESM loan in order to avoid an increase in its debt level and a bail-in of its creditors.

4.3.2 Detailed Assessment

The establishment of the ESM backstop requires an amendment of the ESM Treaty. Drafts for this amendment are not yet available. Subject to subsequent substantiation, the political agreements of 4 December will be assessed below.

By simultaneously **deleting the ESM instrument for direct bank recapitalisation** (EUR 60 billion), **the ESM backstop will not lead to higher risks for national budgets, at least given the volume of the backstop currently envisaged.** On the contrary, the default probability of an ESM loan to the SRF (and thus to the banking sector of the entire Eurozone) is likely to be much lower than that of a recapitalisation of an individual bank. However, if the volume of the ESM backstop is increased in the future – for example due to rising bank deposits – the risks may increase. They are capped by the upper limit for the backstop; this cap cannot be changed without unanimous approval.

It is also **positive** – and constitutionally necessary – that **Germany cannot be outvoted in ESM decisions regarding activating the backstop and increasing its volume.** In view of Germany's high capital share of 27% in the ESM, this also applies to the urgency procedure, which enables decisions with a majority of 85%. In the run-up to the Eurogroup, some Euro States had pleaded for the Executive Director of the ESM to be able to activate the backstop without a majority vote in the emergency procedure.

It is unlikely that the ESM backstop will be introduced before 2024. Without a unanimous amendment to the Agreement (IGA) on the transfer and mutualisation of contributions to the SRF, until 2024, only the banks of the Euro State affected by a bank resolution are liable for the repayment of ESM loans to the SRF.[28]

The effects of the condition that fiscal neutrality must be given in the medium term cannot be accurately assessed yet. Given strict application – i.e. credit periods of three to a maximum of five years, within which the remaining banks in the Eurozone must be able to transfer sufficient funds to the SRF to repay the ESM loan – the **amount of ESM loans to the SRF, which is still "fiscally neutral in the medium term", will be limited.** The reason for this is that the remaining banks in the Eurozone will simultaneously have to make extraordinary ex-post contributions to the SRF to replenish it. This additional burden has a negative impact on the ability of banks to transfer funds to the SRF in order to repay the ESM loan within five years. If the principle of fiscal neutrality is interpreted strictly, it will limit the extent of ESM assistance to the SRF in practice.

Also **still to be clarified is the** envisaged **possibility of the ESM to provide liquidity to banks in liquidation.** For example, it is unclear, whether the SRF will make these funds available to the bank concerned and receive ESM assistance via the backstop, or whether the ESM will make these funds available directly to the bank concerned. Until now, this liquidity has usually been provided through the ECB's Emergency Liquidity Assistance (ELA). **On the one hand, it is important to minimise the resulting default risks for the ESM. On the other hand, any conditions attached by the ESM to such liquidity provision may interfere with the powers of the Single Resolution Board (SRB),** which has to decide on the specific bank resolution measures.

[28] Art. 5 para. 1 lit. e IGA.