

## **European Stability Mechanism**

### **The High Level Principles for Risk Management**

#### **Preface**

On June 24<sup>th</sup> 2011, the European Council decided to establish a permanent crisis resolution mechanism – the European Stability Mechanism (ESM) – to perform the following activities:

- a) provide loans to member states in financial difficulties
- b) issue bonds or other debt instruments on the market to raise the funds needed
- c) perform operations in the primary and secondary Euro sovereign debt markets
- d) act to execute assistance in the context of a precautionary program
- e) finance recapitalizations of financial institutions through loans to governments including in non-program countries

The ESM will use a flexible funding strategy so as to ensure access to broad funding sources and enable it to extend financial assistance packages to Member States under various market conditions. Flexibility is achieved in applying a diversified funding strategy.

Financial assistance from the ESM will in all cases be activated on a request from a Member State to the Chairperson of the ESM's board of governors. ESM loans to member states will enjoy preferred creditor status in a similar fashion to those of the IMF, whilst accepting preferred creditor status of the IMF over the ESM (except for countries under a European financial assistance program at the signing of the ESM treaty).

The ESM is an intergovernmental organization under public international law. The ESM has authorized capital of 700 billion EUR, of which, according to the Eurogroup decision of March 30<sup>th</sup> 2012, 80 billion EUR will be paid in over the next two years. ESM has an expected lending capacity of 500 billion EUR. During the transitory phase from 2013 to 2014, Member States commit to accelerate, if needed, the provision of appropriate capital in order to maintain a minimum 15 per cent ratio between paid-in capital and the outstanding amount of ESM financed assistance. This capital will be invested according to an approved strategy, reflecting due caution and purpose.

The activities of ESM and its various instruments are described in separate documents and include the basic purpose and principles of engagement. These documents are part of the documentation set that will be available at the inauguration of the ESM as an International Institution.

The High Level Principles for Risk Management are the governing part of a detailed documentation, for the use of the ESM team to translate the principles in a comprehensive risk policy.

# 1 Introduction

## 1.1 Purpose

By this High Level Principles of Risk Management (“High Level Principles”), the Board of Directors defines the main principles that apply to identifying, measuring, mitigating, following up and reporting the risks associated with activities conducted by the ESM.

## 1.2 Scope and applicability

The High Level Principles set the minimum standards and do not limit the responsibility for risk management.

The High Level Principles are complemented by the Risk Policy, which shall be approved by the Board of Directors and specify technical provisions on risk management rules and procedures.

The High Level Principles and the Risk Policy define the risk management framework of the ESM, which shall be shared, understood and applied by all actors of the ESM.

ESM applies elements of its High Level Principles and the Risk Policy to the provision of financial support to ESM Members to the extent that they do not cover counterparty risk. As such, financial assistance in line with the purpose of ESM is granted to ESM Members experiencing severe financial problems, if indispensable to safeguard the financial stability of the euro area as a whole and of its Member States.

# 2 Glossary

The following terms and definitions apply:

- **Risk** is the adverse (financial and non-financial) effect of uncertainty on the objectives of the organization.
- **Risk aggregation** is the sum of all risks within the organization.
- **Risk analysis** is the process to understand the risk and its evolution over time.
- **Risk appetite** is the amount of risk that the organization is willing to pursue or retain.
- **Risk assessment** is the overall process of risk identification and risk analysis.
- **Risk evaluation** is the process of comparing results of risk analysis with risk criteria to determine whether the risk and its magnitude are acceptable or tolerable.
- **Risk identification** is the process of recognizing and describing risks.
- **Risk management framework** includes components that provide the foundation and organizational arrangements for designing, implementing, monitoring, reviewing and continually improving risk management throughout the organization. The risk management framework of the ESM is defined by the documents “The High Level Principles for Risk Management” and the “Risk Policy”.
- **Risk management** is the set of activities spanning risk assessment, risk evaluation and risk reporting.

- **Risk policy** is a document detailing the technical implementation of risk management within the organization.
- **Risk manager** is a person who by virtue of expertise or authority has a leading role for the risk management process.
- **Risk profile** is the overview of the total risk by types of risk.
- **Risk reporting** is the communication of relevant risk facts to decision makers and enables decision makers to make informed decisions on risk.
- **Business function** is an organization unit that forms a logical grouping of business processes and expertise.

### 3 Principles

#### 3.1 Risk appetite

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

The targeted risk appetite shall preserve the ESM's funding capacity, ensure the highest creditworthiness and avoid unexpected capital calls. The risk appetite shall account for the minimum capital requirements, leverage and return on paid capital and shall be detailed in the Risk Policy.

The risk appetite shall be set in the form of a global risk budget quantifying the maximal tolerable potential loss over a defined time horizon with an agreed probability covering all financial and non-financial risks of the ESM as described in Chapter 5 of this document, covering both on- and off-balance sheet items.

The risk profile shall be defined by a set of limits applicable to curtail all types of risks.

The ESM does not aim to generate profit on financial support granted to beneficiary member states and shall not provide incentives for speculative exposures of its investment portfolio.

#### 3.2 Risk culture

Risk culture is the combined set of individual and corporate values, attitudes, competencies and behavior that determine ESM's commitment to and style of risk management. Main components shall include:

- a) Staff at all levels shall clearly understand their responsibilities with respect to risk management.
- b) The ESM shall apply the 'four eyes' principle requiring more than one person to be involved to complete a task. The ESM shall also adopt procedures with clearly drawn lines of authority, segregated powers and duties, and appropriate checks and balances across the organization.
- c) Risk management activities across the organization shall be carried out by sufficient number of qualified staff with necessary experience, technical capabilities and adequate access to resources. Staff involved in risk management activities must act as whistleblowers when necessary.
- d) Management shall emphasize high ethical standards at all levels and shall send a consistent message to the whole organization that is fully supportive of the risk management framework through their actions and words.

### **3.3 Risk measurement**

All risks shall be quantified using the measurements that are most appropriate for the management and control of the respective types of risk. These measurements shall be defined in the Risk Policy.

The ESM shall apply multiple risk measurements for each type of risk, capture both current and forward looking aspects, and use both quantitative and qualitative information to avoid overreliance on a single risk measurement. This applies to on- and off-balance sheet items.

Regular risk measurement shall be supplemented by stress tests and scenario analysis to identify high-risk areas and to evaluate the combined effects of financial shocks.

### **3.4 Continuous improvement**

The ESM shall continuously improve the management of risk. Staff at all levels shall seek to achieve changes in processes in order to improve efficiency and quality of the ESM risk management on a day-to-day basis.

The ESM shall annually conduct a risk self-assessment in order to review the current state and progress of the risk management, and to identify measures for improvement.

### **3.5 Approval process for new tools and instruments**

Introducing new tools or instruments or significant changes to existing ones, shall follow an internally approved and well-documented “New Tool and Instrument Approval Policy”.

The Risk Management Department shall have a prominent role in the process of approving new tools or instruments or significant changes to existing ones. The Risk Management Department shall ensure compliance with this process whenever appropriate.

Analysis of new tools shall include an assurance that the organization possesses adequate internal risk tools and expertise to understand and monitor the risks associated with them. The analysis shall include the identification of conflicts of interest related to new tools and instruments.

## **4 Governance**

### **4.1 First line of defense - Direct responsibility of management and control of risk**

Departments and business functions assume direct responsibility for the day-to-day management of risk. All staff are responsible for ensuring that risks relating to their operations are identified, followed up and reported to the Risk Department.

Breaches of limits shall be immediately reported to the competent authority according to modalities detailed in the Risk Policy.

### **4.2 Second line of defense – Enforcement and oversight**

The Board of Directors shall be accountable for the adequacy of the ESM’s risk management framework comprising both the High Level Principles and the Risk Policy.

- a) The Board of Directors shall approve the Risk Policy upon proposal of the Managing Director and the Head of Risk.
- b) The Board of Directors shall specify the risk appetite of the ESM within the Risk Policy.

- c) The Board of Directors shall be periodically informed on the state of the implementation of the risk management framework, of the aggregate figures of exposures and of violations of the risk management framework, if they occurred. Further, the Board of Directors shall be periodically informed on the decisions and actions to mitigate risk taken when breaches occurred.
- d) The Board of Directors shall establish a risk committee to advise the Board of Directors on the overall current and future risk appetite and strategy and assist the Board of Directors in overseeing the implementation of that strategy by the Managing Director. The Board of Directors shall retain overall responsibility for risks.

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

The Risk Management Department exercises central oversight of risk and ensures the comprehensiveness and consistent implementation of the risk management framework by all business functions. The Risk Management Department shall be responsible for:

- a) acting as an independent function of the ESM.
- b) developing and maintain a regular inventory of the risks borne by the ESM.
- c) identifying, assessing and proposing alternatives to mitigate the overall risks borne by the ESM.
- d) reporting of risks in a consistent way to Management and the Board of Directors putting forward its own judgment.
- e) validating monitoring tools and methodologies, and ensures their consistent implementation.
- f) implementing an appropriate warning system, assessment and escalation of limit breaches, and shall recommend countermeasures to the Managing Director or staff concerned.
- g) fostering a risk culture throughout the whole organization and lead the work of the Internal Risk Committee.

The head of the Risk Management Department (“Head of Risk”) is a direct report to the Managing Director. The Head of Risk is responsible and accountable for informing the Managing Director on all risks to ensure enforcement and oversight. The Managing Director, as Chairman of the Board of Directors, shall report the enforcement and oversight related information to the Board of Directors.

- a) The roles and responsibilities of the Head of Risk shall be independent of and segregated from other executive functions and business line responsibilities.
- b) The Head of Risk shall have access to all information necessary to evaluate risk.
- c) The Head of Risk shall be also prominently part of investment decisions and approval of new products.
- d) The Head of Risk shall also report and have direct access to the Board of Directors and its risk committee without impediment. Beyond periodic reporting, the Head of risk shall have the ability to engage with the Board of Directors.

The Internal Risk Committee is composed of management board members with a reasonable representation across business functions. The ECB and the European Commission are granted an open invitation to the Internal Risk Committee.

- a) Members of the Internal Risk Committee shall act as a risk manager in their business function.
- b) The Head of Risk shall be the chairperson of the Internal Risk Committee.
- c) The Internal Risk Committee shall translate the risk appetite into the internal limit structure, which shall be detailed in the Risk Policy and approved by the Board of Directors.

- d) The Internal Risk Committee shall assist the Board of Directors in ensuring the adequacy of the ESM's internal limit structure and limit setting, and in providing recommendations on changes of the internal limit structure.
- e) The Internal Risk Committee shall provide recommendations on identification of relevant risks, and on the suitability of methods to monitor and manage them.
- f) The Internal Risk Committee shall conduct on a periodical basis a risk self-assessment and shall report the result to the Managing Director.
- g) The Internal Risk Committee shall have authority to suggest to the Managing Director to undertake investigations on risk management (including outsourced activities) through either internal or external audit teams.

### **4.3 Third line of defense - Independent assurance**

Internal Audit is an independent function and shall be responsible for providing to the Board of Directors a reasonable assurance that the risk management function is operating properly and efficiently. Internal Audit shall report to the Managing Director and shall have also direct access to the Board of Auditors on issues related to risk management.

The external auditor performs its statutory duties, conforming with applicable law and content of the ESM treaty, including risk.

The Board of Auditors is an independent function appointed by the Board of Governors and shall draw up independent audits in accordance with Article 30 of the Treaty establishing the European Stability Mechanism and Article 24.4 of the By-Laws

## **5 Types of risks and mitigations**

### **5.1 Financial risks**

Counterparty risk is defined as the potential for loss arising from inability of a counterparty to fulfill its contractual obligations for full value when due or at any time thereafter. Credit risk is considered a particular form of counterparty risk and derives from the lending and support operations to member states, investment of paid-in capital, placement of possible excess liquidity, and hedging operations.

- a) Counterparty Risk shall be minimized by implementing rules and procedures limiting investments to minimal credit standing requirements and using other mitigation techniques the management might retain appropriate and/or adopting continuous linked settlements.
- b) On the derivative contracts, the ESM shall limit itself to counterparties complying with high credit standards as defined in the investment guidelines. Further, the ESM shall enter into unilateral collateral agreement with those counterparties. Likewise, excess liquidity shall be invested in well rated paper according to criteria detailed in the investment guidelines.

Settlement risk is defined as the potential for loss arising from the failure of one or more counterparties to settle transactions in an exchange-for-value model when settlement of various legs of a transaction happens at different times. Settlement risk shall be minimized by adopting novation procedures via clearing houses and/or adopting continuous linked settlements.

Credit concentration risk and correlation risk is defined as the potential for loss arising from uneven exposure to a particular group of counterparties and correlation between individual exposures. Credit concentration risk and correlation risk shall be minimized by limiting exposures by different

group categories for the investment of paid-in capital and reserves. Following its mandate, the ESM shall accept credit risk concentration from financial assistance to beneficiary member states.

Funding liquidity risk is defined as inability to raise money in a timely manner. Due to this the ESM could be unable to settle obligations in a timely fashion and be held in breach of obligations. Funding liquidity risk shall be minimized by maintaining multiple credit lines and/or maintaining minimal balance levels between current assets and current liabilities.

Market liquidity risk is defined as the potential for loss arising from a position that cannot easily be unwound or offset at short notice without significantly negatively influencing the market price because of inadequate market depth or market disruption. Market liquidity risk shall be minimized by adopting adequate measurements that allow the timely detection of liquidity deteriorations.

Liquidity concentration risk is defined as the potential loss arising from concentrations in assets and liabilities as major sources of liquidity. A concentration in assets can disrupt an institution's ability to generate cash in times of illiquidity or reduced market liquidity for certain asset classes. A liability concentration (or funding concentration) exists when the funding structure of the institution makes the ESM vulnerable to a single event or a single factor, such as a significant and sudden withdrawal of funds or inadequate access to new funding. Liquidity concentration risk shall be minimized by securing credit lines.

Interest rate risk is defined as potential for loss arising from adverse movements in interest rates. Main sources of interest rate risk include asset or liability repricing, triggered by covenants or market movements, yield curve shifts, asymmetrical payoff characteristics of instruments with embedded optionality, imperfect correlation in the adjustment of rates earned and paid, and changes in the funding or lending spread. Interest rate risk shall be minimized using interest rate swap and forward rate agreements.

Foreign exchange risk is defined as the potential for loss arising from changes in the exchange rates. Foreign exchange risk shall be minimized by limiting exposure to certain currencies.

Further risk mitigation techniques considered appropriate and coherent with this guideline shall be specified in the Risk Policy.

## **5.2 Non-financial risks**

Operational risk is defined as the potential loss, inability to fulfill its mandate or reputational damage resulting from inadequate or failed internal processes, people and systems or from external events. Operational risk includes legal risks, physical or environmental risks. Reputational damage is defined as the prospective negative impact on the ESM fulfilling its mandate derived from an adverse perception of ESM. Operational risk losses lead to P&L write downs, external costs incurred as a consequence of the event, specific provisions following the risk event or pending losses.

- a) The Risk Policy shall detail processes, risk management tools and a full control infrastructure to ensure a very high level of control on the operational risks inherent to activities of the ESM. This shall include general and specific procedures, permanent supervision, business continuity plans and functions dedicated to the oversight and management of specific types of operational risk such as fraud, risks pertaining to payment systems, legal risks, information systems security risks and non-compliance risks.
- b) For outsourced activities, the ESM should refer to best business practices on outsourcing within the financial sector and should implement methods and procedures compliant with those standards.

Compliance risk is defined as the potential loss or adverse effect on reputation arising from non-conformance with laws, regulations, rules, related self-regulatory organization standards and codes of conduct. Compliance risk shall be mitigated by adopting appropriate internal procedures and/or using other mitigation techniques. The Code of Conduct, as part of the legal framework, defines the fundamental ethical principles to be assumed by the ESM's personnel. These include e.g. the requirement regarding the employee's integrity and loyalty, guidelines for handling conflicts of interest, prohibitions on insider trading, restrictions on financial interest and rules regarding information secrecy.

## **6 Reporting to the Board of Directors**

The periodic risk reporting to the Board of Directors is inclusive of narrative sections explaining the risk profile evolution over the period under analysis. The risk reporting shall inform about risk exposures at aggregate level, and provide a summary of breaches to the risk limits with the action taken to cope with the risk breaches and provide assurance regarding the compliance with the risk management framework. The corresponding reporting requirements will be set in the Risk Policy.