European Stability Mechanism

2017

ANNUAL REPORT

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Contents

Introduction to the ESM

The European Stability Mechanism (ESM) is a crisis resolution mechanism established by the euro area countries. The ESM's mission is to provide 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 Luxembourg-based ESM raises funds by issuing debt instruments, which are purchased by institutional investors. The proceeds enable the intergovernmental institution, in operation since 8 October 2012, to provide its Members the following types of financial assistance:

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

ESM provides financial assistance to beneficiary Members addressing weaknesses in their economies through reforms which are jointly agreed by that Member, the European Commission, in liaison with the European Central Bank (ECB) and, where applicable, the International Monetary Fund (IMF). The reforms are required to be consistent with the measures of economic policy coordination provided for in the Treaty on the Functioning of the European Union.

More information about the ESM can be found on our website:
www.esm.europa.eu.

Note: The ESM 2017 Annual Report contains the audited financial statements as at 31 December 2017, together with the report of the external auditor in respect of their audit concerning these financial statements, and the report of the Board of Auditors in respect of these financial statements. The description of ESM policies and activities covers the 2017 financial year, except when stated otherwise. The information related to the composition of the Board of Governors (BoG) and Board of Directors (BoD) reflects their composition as of 15 May 2018. The economic development report (Chapter 1) includes certain information available up to 3 May 2018, but all historic financial data there set out is limited to the period to 31 December 2017.

“As a permanent institution, the ESM makes the monetary union more robust, and enhances the resilience of its economy.”

KLAUS REGLING

Managing Director

European Stability Mechanism

Message from the Managing Director

The European Stability Mechanism was set up to protect the euro area against the worst blows dealt by an economic crisis. Such crises happen from time to time, and have done so for hundreds of years. They can spring up suddenly, seemingly out of nowhere, for reasons that may be poorly understood at first. The problems that cause a crisis often build up for a long time – but we do not always heed the warning signals.

It was like that in the last financial crisis, a period from which the ESM was born. Several countries accumulated unsustainable misalignments during the first decade of monetary union, in the form of high debt levels, a loss of competitiveness, and growing current account deficits. In addition, the euro area was not well-equipped institutionally to deal with a serious crisis, and the monetary union threatened to break up. The rapid establishment of the ESM – and first the temporary European Financial Stability Facility (EFSF) – could not turn the clock back on the crisis. But these two institutions shielded Europe against a far worse outcome: the departure of one or more countries from the euro area.

The ESM is now a permanent feature of the monetary union and of the global financial safety net. It functions as an emergency system, which has helped to keep the euro together. Four of the five countries that were in EFSF or ESM assistance programmes are clear success stories. Greece has a chance to join this group, if it continues to implement reforms, also after the end of its programme in August. As a permanent institution, the ESM makes the monetary union more robust, and enhances the resilience of its economy. These are not abstract concepts: it means fewer job losses, and less economic damage when the next crisis hits.

But the euro area's emergency defence system is still not as solid as it could be. That is understandable: Europe had to come up with a broad policy package very quickly at the height of the crisis. Setting up the ESM was only one part of that. And while the crisis response was very successful, not all risks have gone away. Remaining deficiencies should be fixed now, in order to better prepare for the next crisis.

These steps, importantly, are relatively small in comparison to the work that has already been done. They do not represent a grand architectural design for new European institutions. I am a strong proponent of the principle of subsidiarity – taking decisions at the lowest possible level. Many things can be done better at the national or regional level. But there are a few tasks that countries simply cannot resolve on their own. Examples are control of the European Union's external borders, the fight against terrorism and dealing with climate change. These are areas where Europe needs to be strong, and where it can bring something to its citizens that countries cannot. Defending the integrity of the monetary union – and the many benefits that the single currency brings – are also areas where cooperation leads to better results than individual countries' actions.

Now is a good time to work on these remaining reforms, because the economy is thriving. The euro crisis is behind us, and Europe has come out of it stronger than before. The economy has been expanding almost twice as fast as the potential growth rate. Growth is spread evenly, with some of the former programme countries showing among the highest growth rates in the euro area. Investors – whom we meet on the frequent roadshows the ESM does across the globe – are telling us that they are seeing Europe as a safe haven for their money in today's world. This is a marked difference from a year ago, when many saw a number of elections in Europe as creating uncertainty.

Of course the risk of political disruption never goes away. Constant debate is the basis of democratic decision-making – and that debate can sometimes be prolonged and unruly. But I expect we can make real progress this year in those areas where it is most needed.

As an economist, I believe the most important issue that the euro area needs to tackle in a broad sense is that of economic risk-sharing. This is underdeveloped in the euro area, compared to the United States and to large European countries such as Germany and France. More risk-sharing means the effects of a shock are spread more easily across borders, and different cyclical developments are corrected automatically to some extent. That would make the euro area more stable, and less vulnerable. Most risk-sharing should take place through private channels – such as banks, financial markets, and cross-border capital flows – while fiscal tools can play a complementary role.

The plans to deepen monetary union that European Council President Donald Tusk laid out in December would certainly promote risk-sharing in the euro area, as would the Capital Markets Union, promoted by the European Commission, and supported by most market participants.

The first priority on the agenda is completing Banking Union. Essential steps have already been taken in the past, through the establishment of the Single Supervisory Mechanism and the Single Resolution Fund. The latter needs a financial backstop, so that it has full firepower in a big crisis. The ESM could play the role of a backstop, if that is the wish of our Members. An equally important second step to completing Banking Union is a common deposit insurance for Europe, which would reduce the risk of national bank runs during a crisis. To take that step, legacy issues need to be sorted out, something that our Members are working on. The speed at which a common deposit insurance can be implemented will depend on the progress in dealing with non-performing loans, sovereign bond exposure of banks, harmonising insolvency regimes, and the build-up of bail-inable capital.

The next point on the agenda is to develop the role of the ESM. A stronger, more powerful ESM is not a goal in itself. But our institution has built up a broad expertise and practical know-how since its inception, which makes it a natural place to house some of the new functions needed in the euro area.

Other than the backstop for the SRF, the ESM could play a greater role in future rescue programmes. Designing, negotiating, and monitoring these programmes could become a joint task of the European Commission and the ESM, without any unnecessary overlap of responsibilities, and fully respecting the role of the Commission laid down in the EU Treaty. The ESM could also play a role in a potential sovereign debt restructuring framework, designed to make settlements with private creditors more predictable and more transparent, without introducing any rigid or automatic rules. Finally, I support the integration of the ESM into the EU Treaty. This should not, however, happen through secondary law, but instead at the moment that the EU Treaty, one day, is changed. The model of the European Investment Bank seems to be an appropriate one for the ESM, with its own protocol in the EU Treaty, its own capital, and a board with representatives from member states. Until then, the ESM can continue successfully as an intergovernmental institution.

Fiscal matters are the third and final point on the agenda to deepen monetary union. But these are particularly controversial. There are a wide range of ideas, such as a euro area budget for investments, a revolving fund to tackle asymmetric shocks, and a euro area finance minister. The debate on these fiscal issues needs to progress.

In my view, a monetary union should have a certain fiscal capacity to broaden the fiscal space at the national level. That can be done without adding to fiscal transfers – which are traditionally provided via the EU budget to promote real convergence – and without debt mutualisation. Several tools are imaginable for such a fiscal capacity, and some of them have been successfully used in the United States for a long time. Examples are a rainy day fund, or a complementary unemployment insurance. A new ESM facility, with shorter maturities and less conditionality than a full-scale ESM programme, could be useful in this context, and would be relatively easy to implement – at least in a technical sense.

With these new measures, Europe would be better prepared when the next crisis hits. That is also in the interest of the ESM, because it would protect our outstanding claims. The more such measures are implemented, the more resilient the euro area becomes, and the less vulnerable. That means there would be less need for traditional ESM adjustment programmes – and that would be very welcome.

Letter of transmittal to the Board of Governors

21 June 2018

Dear Chairperson,

I have the honour of presenting to the Board of Governors (BoG) the annual report in respect of the financial year 2017, 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 during 2017. It also contains the audited financial statements as at 31 December 2017, as drawn up by the Board of Directors (BoD) on 27 March 2018 pursuant to Article 21 of the By-Laws, which are presented in Chapter IV. Furthermore, the report of the external auditor in respect of the financial statements is presented in Chapter V and the report of the Board of Auditors in respect of the financial statements in Chapter VI. The independent external audit was monitored and reviewed by the Board of Auditors (BoA) as required by Article 24(4) of the By-Laws.

Klaus Regling
Managing Director

2017 ESM highlights

20 FEB
BoG reappoints Klaus Regling as Managing Director of the ESM for another five-year term as of 8 October 2017.

01 JUN
BoD approves a Spanish request to make a voluntary early repayment of €1 billion on its ESM loan.

15 JUN
High-Level Independent Evaluator presents findings of the first evaluation of ESM and EFSF assistance programmes to the BoG, which asks the ESM to follow up on the recommendations.

05 JUL
Following the second review of the ESM programme for Greece, the BoG signs off on a supplemental agreement on further Greek policy reform steps. Two days later, the BoD approves a disbursement of €8.5 billion in assistance, including €7.7 billion for debt servicing needs and arrears clearance. On 26 October, the BoD approves the release of the remaining €800 million under the third tranche of ESM financial assistance.

08 OCT
ESM marks its fifth anniversary.

11 OCT
ESM signs agreements with two other regional financing arrangements, Fondo Latinoamericano de Reservas (FLAR) and ASEAN+3 Macroeconomic Research Office (AMRO), to strengthen collaboration in matters of common interest.

24 OCT
ESM raises €3 billion in its first non-euro debt issue, a US dollar-denominated 5-year bond, successfully broadening the ESM's investor base.

26 OCT
BoD approves a Spanish request to make a voluntary early repayment of €2 billion on its ESM loan.

04 DEC
ESM finishes implementing short-term debt measures for Greece, designed to reduce the interest rate risk on Greece's outstanding loans and thereby its long-term debt burden.

BoG appoints Portuguese Finance Minister and Eurogroup President Mário Centeno its chairperson as of 13 January 2018, replacing Jeroen Dijsselbloem.

20 DEC
BoG confirms ESM's maximum lending volume and adequacy of its authorised capital stock.

Message from Mário Centeno Chairperson of the ESM Board of Governors

(from 13 January 2018)

The ESM has a crucial role to play in strengthening economic resilience and preserving financial stability in the euro area.

From a temporary body put in place at the height of the crisis, the ESM has grown into a permanent institution embedded in plans to overhaul the European Economic and Monetary Union (EMU).

Over the past seven years, it has fulfilled its mandate to provide financial assistance to five countries in need.

The ESM is, in itself, a success story borne of the crisis. Its creation filled an institutional gap in the EMU. It built a reputation as a credible and reliable institution with a solid and robust capital structure.

The ESM became instrumental in developing EMU further. No wonder the euro area finance ministers are planning to take the ESM to the next level, reinforcing its mandate on crisis management.

To upgrade the ESM is particularly relevant as the IMF's importance in the management of future euro crises may dwindle.

The euro area finance ministers will continue to take into account the recommendations made by the independent evaluator Gertrude Tumpel-Gugerell in the evaluation report.

The ESM should play an extended role in programme design and monitoring, provided there is no overlap with the European Commission. We must recognise the institution's capacity and expertise developed during the crisis in producing debt sustainability analyses.

With the highest paid-in capital of all international financial institutions and substantial firepower, the ESM can also provide a credible backstop to banking union.

Our priority must be to deliver on policies. Discussions on governance and institutional questions are important but they can follow later.

As a successful European project, I believe the ESM's place is in the EU Treaty, in line with the statutes of other European institutions like the European Investment Bank or the European Central Bank. Until this becomes feasible, we must develop the ESM's role under the current institutional setting.

Message from Jeroen Dijsselbloem Former Chairperson of the ESM Board of Governors

(11 February 2013 – 12 January 2018)

When I became chairman of the ESM Board of Governors in February 2013, it was an important goal for me to allow the institution to develop its full potential as the crisis resolution mechanism that the currency union was in need of.

Looking back, I can now say the ESM did a remarkable job. In five years, this firewall for euro area sovereigns has developed into a strong, independent, and efficient organisation.

The ESM rapidly helped euro area countries in trouble to get back on their feet again. Without it, the euro area would not have been able to put the crisis behind it so successfully.

This was confirmed by last year's report by the independent evaluator, which said establishing the ESM was a key milestone in the euro area's response to the economic crisis.

Extensive discussions on the future of the European Economic and Monetary Union – including the role of the ESM – took place in the last meetings I chaired as president of the Eurogroup. Topics were how to strengthen its role in crisis management, its role in completing banking union, and its possible role in any future fiscal facilities.

In short, we were looking how member states could make even better use of the ESM's potential. To me, that is the biggest compliment this young institution can get.

As I write this, the euro area's economic performance is impressive. Each euro area country is growing, unemployment is falling, and public finances are on a sounder footing.

But more work is needed at all levels. Euro area countries should continue strengthening their growth potential, and become more resilient against possible future shocks. All that would make it less likely that ESM programmes are needed again anytime soon. However, as crises do happen in our economic system, it is good to know that the ESM is the euro area's stability anchor – an anchor the euro area will always be able to rely on.

Let me conclude by thanking ESM Managing Director Klaus Regling and his staff for their hard work over the last five years. It has been a huge privilege to be chairman of the ESM Board of Governors, especially in such challenging times.

The ESM: ready for the future

The ESM is an organisation that lent billions of euros during the crisis to help euro area countries in trouble and played a crucial role in protecting the integrity of the euro.

The ESM is also a group of 170 people, who have dedicated their expertise and energy to this exceptional project.

The sudden eruption of the crisis required an equally rapid response. It is rare that a new European body needs to be fully operational so soon after its creation. And so the ESM became a new, more entrepreneurial type of public sector institution.

The ESM has by now firmly established itself as an international financial institution (IFI). But as a young institution, it remains flexible enough to adapt quickly when needed.

In this annual report, we give the floor to some of the women and men who have contributed to the ESM's success. Of all age groups, ESM staff members come from 42 different countries, with widely varying backgrounds and specialities, acquired in jobs in the private or public sector.

What are some of the skills needed by the people you'll meet in this report?

With its predecessor the European Financial Stability Facility (EFSF), the ESM provided loans to Ireland, Greece, Spain, Cyprus, and Portugal. To understand the economies of these countries requires strong analytical skills. Not only of fiscal matters but also of the real economy and financial sector.

ESM economists and banking experts travel to these countries for negotiations, and for discussions with other creditors, with the support of the lending team. Once a programme is completed, our experts run the Early Warning System to continuously assess whether a beneficiary Member State is able to repay its loans. By regularly publishing articles in the ESM working paper and discussion paper series and in economic journals, they broaden their academic credentials and share ESM expertise with the academic world.

Other policy experts analyse the current proposals to deepen the Economic and Monetary Union. Plans to complete banking union are complex and need to balance the interests of the 19 euro area countries. The ESM combines economic and financial market knowledge with an understanding of political realities. When thinking about the future of the euro area, we focus on what would be best to make the euro area more resilient.

The ESM has already put together a strong track record. It is able to execute its important mission with forward-planning and a well-developed toolkit. It delivers a crucial contribution to the stability of the euro area, and is ready to take on new challenges. In order to do so, it has built up a set of professional skills over the past five years that allow it to provide strong and innovative solutions to the challenges the euro area faces.

The ESM's position as an IFI necessitates a thorough knowledge of international law and practice. Legal experts provide this knowledge. The corporate governance team ensures smooth relations with the ESM

"The ESM is committed to maintaining a talented, enthusiastic, professional staff. We have put together an expert team from across the globe dedicated to safeguarding the euro area's financial stability. We work daily with a group of people from 42 different nationalities. Some 27% come from outside the euro area; 37% are women. We value all our diversity and use it in pursuit of our common goal."

MAYUMI TAKAGI

Human Resources Assistant, Talent Management Operations

> The ESM Legal department welcomes and stands ready to be actively involved in the initiatives that are being developed for the deepening of European Economic and Monetary Union. Our professional legal expertise, paired with respect for the expertise of peer institutions and understanding of the political dimensions, enables us to constructively contribute to this important challenge.

JOANNE ANKUM-BRINKMAN
Principal Legal Counsel

shareholders and prepares the decisions and meetings of the ESM Boards, while the internal policies team develops policies in line with best practices. The human resources team has the specialised skills needed to recruit and retain staff from all over the world.

The ESM has a strong financial capacity. The EFSF and the ESM together have disbursed €273 billion in loans since inception. The ESM has an unused lending capacity of €380 billion, after taking into account the maximum possible disbursements to Greece.

The ESM operates in financial markets every day: not only because it raises the money it needs from investors to provide loans to beneficiary Member States, but also because its investment team adjusts the structure of its investment portfolios to changing market conditions to ensure the preservation of the paid-in capital of €80.4 billion.[1] This money was paid in by the 19 euro area countries, and is by far the largest paid-in capital of any IFI.

These financial activities give the ESM insights into financial markets and investor sentiment. Over the course of 2017, the ESM presented itself to investors in 124 different meetings in 27 countries. Funding staff raised €61 billion in long-term bonds in 21 different transactions, issued more than €34 billion of ESM bills in 23 auctions, using derivatives to manage risk. Because the money is borrowed on financial markets for shorter periods of time than the length of the loans for which it is used, the Asset and Liability Management (ALM) team mainly monitors the risk associated with mismatches between assets and liabilities.

Such sizeable financial dealings, together with the need to maintain a high creditworthiness in order to fulfil its financial stability mandate, require prudent management and control of the risks inherent in the organisation's day-to-day work. The ESM has a 14-strong risk team, whose Chief Risk Officer reports directly to the Managing Director. The internal audit team is a further line of defence.

The ESM has also built up a state-of-the-art engine room for the money flowing through the organisation. The middle and back office validates and administers all trades.

This off-stage, technology-heavy work forms the backbone of the ESM's operations. New activities such as the first-ever dollar-denominated bond issue and new types of operations involving derivative instruments were successfully implemented in 2017.

Running many complex activities with a relatively small staff requires strong project management. A dedicated project management office ensures robust governance of the ESM project portfolio. Last year, ESM staff spent 6,992 days on projects, equivalent to 32 full-time people.

Lastly, the finance and control team provides accounting and financial reporting, corporate finance and business projects analysis, budgeting and financial administration.

The euro area is discussing its future, and it is possible that the ESM will play a stronger role in that future. The ESM was set up in record time, and, in its short existence, has become highly effective. Its dedicated staff have made it into a flexible and agile organisation. Throughout the pages of this report, you will meet some of these people and hear what they have to say.

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1 As at 31 December 2017.

01 Economic developments

Macroeconomic and financial environment

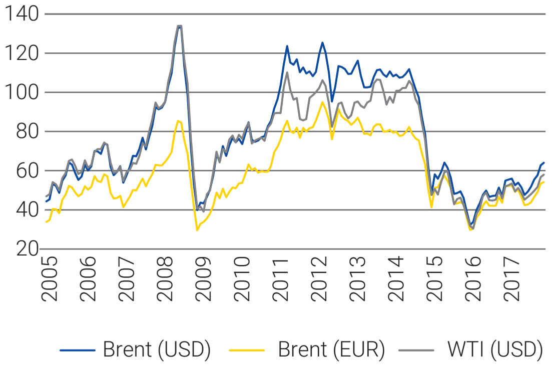
The euro area economy exceeded expectations in 2017, completing its recovery from the crisis and entering a phase of economic expansion. A favourable external environment, accommodative monetary policy, and renewed trust in the common currency bolstered growth. The robust economic upswing has prompted only a muted reaction from inflation. Underlying price pressures are subdued amid a gradual wage acceleration and exchange rate appreciation. The economic outlook is positive overall, but the euro area should prepare itself for slower growth as the economic cycle matures.

Euro area economic performance surpassed expectations

The euro area economy enjoyed another successful year. Real gross domestic product (GDP) growth accelerated to 2.4% in 2017 from 1.8% in 2016. The global economic recovery is well underway. A rise in oil prices and the euro exchange rate corrected some of the previous developments (Figures 1 and 2) with limited impact on euro area economic activity. Monetary policy still provides a considerable stimulus via net asset purchases, the sizeable stock of acquired assets, the forthcoming reinvestments, and by forward guidance on interest rates. Most importantly, the euro area returned to its position as one of the economic leaders, contributing substantially to strong global economic performance.

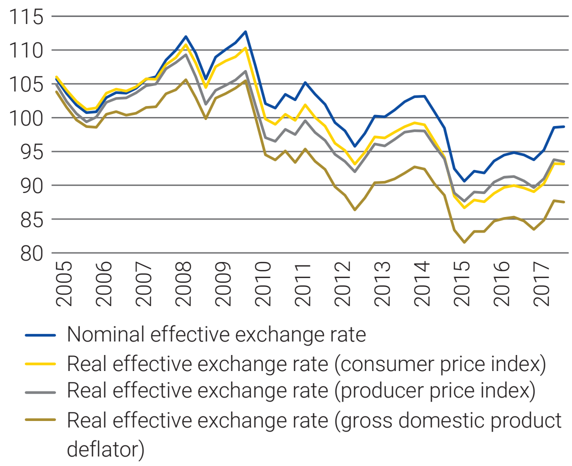
The euro area is also drawing strength from well-balanced economic growth (Figure 3). Private consumption, benefiting from an upswing in employment and moderate wage increases, remains the main engine of growth. Investment is also making a robust contribution to economic momentum, which is important for longer-term prospects. While residential investment remains below the very high pre-crisis levels

Figure 1
Oil prices per barrel



Sources: Financial Times, Haver Analytics

Figure 2
Euro effective exchange rate
(Group of 19 countries, Q1/1999=100)

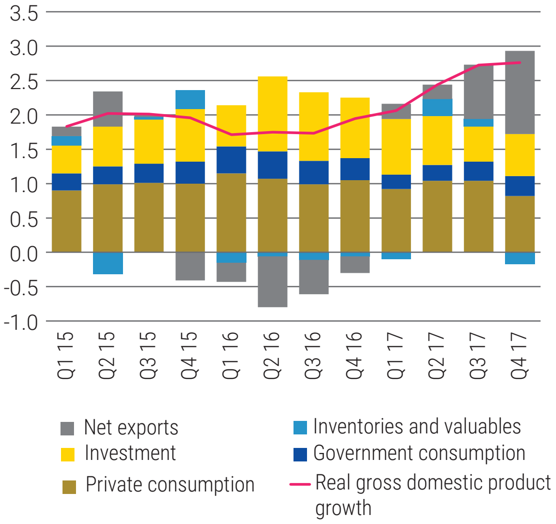


Source: European Central Bank

Figure 3

Contributions to real gross domestic product growth

(y/y growth in %, contributions in percentage points)

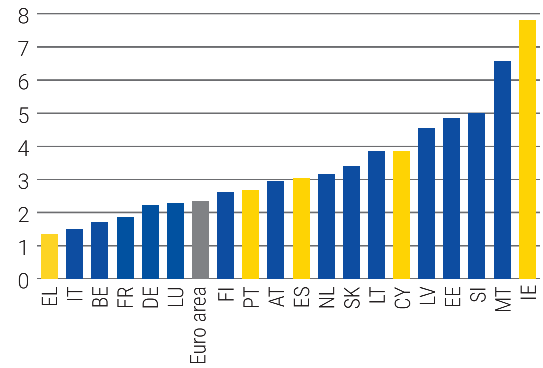


Source: Eurostat

Figure 4

Real gross domestic product growth in 2017

(in %)



Note: EFSF/ESM programme countries in yellow.
Source: Eurostat

and government investment is also still subdued, business investment has fully recovered and no longer represents an impediment to growth. The contribution from external trade turned positive, confirming the competitiveness of the euro area economy.

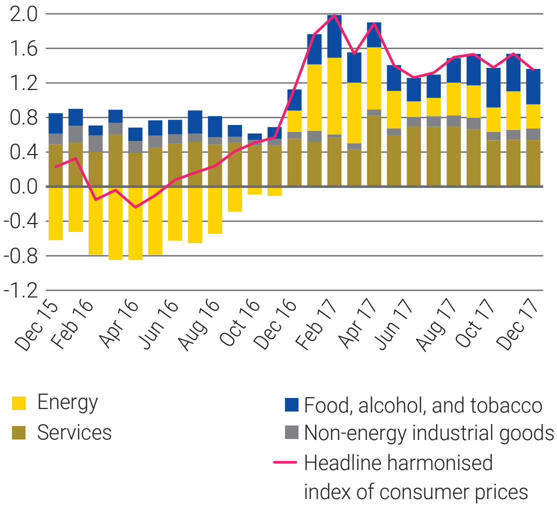
For the last four years, euro area growth has stood well above the estimated potential, which helped the economy recover previous losses. The euro area has largely completed its recovery and entered a phase of economic expansion despite continued slack in labour markets in some countries.

The euro area upturn is synchronised with all member countries recording positive GDP growth rates (Figure 4). EFSF/ESM programme countries, except Greece, outperformed the euro area average as they experienced strong catch-up growth, and also benefitted from successful reforms. Greece, however, successfully recovered from the recession and recorded its highest growth rate since 2007. The euro area experienced cyclical convergence over the last few years, but discernible differences in cyclical positions and labour market conditions persist.

Headline consumer inflation accelerated to 1.5% in 2017, mainly due to the recovery in energy prices (Figures 5 and 6). Core inflation, which strips out the more volatile food and energy components and thus better captures underlying inflationary trends, remained relatively stable throughout the year at around 1%. Inflationary developments remain subdued, despite the economic upswing, mainly due to only gradually accelerating wages and exchange rate appreciation.

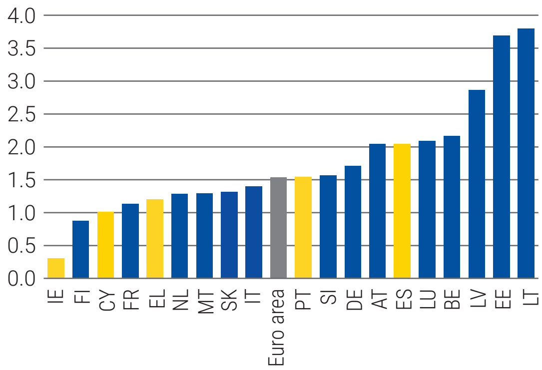
The euro area's headline fiscal balance strengthened and the government debt-to-GDP ratio declined as the economy grew and thanks to favourable borrowing conditions (Figures 7 and 8). However, the underlying

Figure 5
Contributions to harmonised index of consumer price inflation rate
(y/y inflation in %, contributions in percentage points)



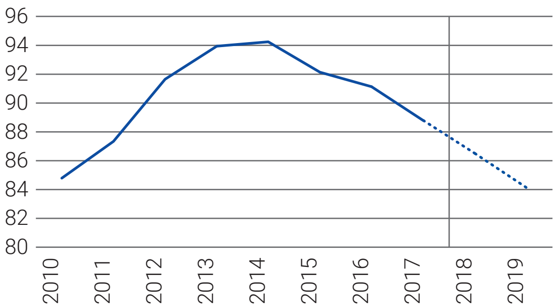
Source: Eurostat

Figure 6
Harmonised index of consumer price inflation rates in 2017
(in %)



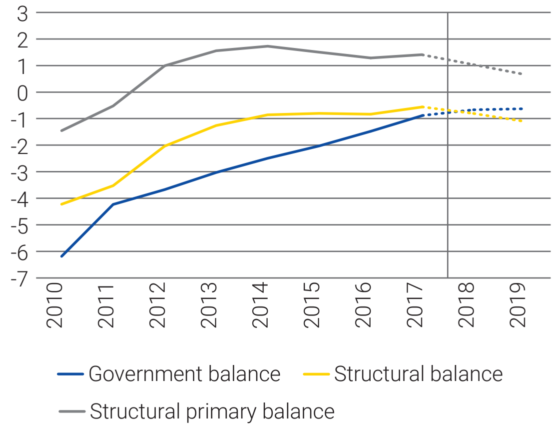
Note: EFSF/ESM programme countries in yellow.
Source: Eurostat

Figure 7
Euro area government debt
(in % of GDP)



Source: European Commission Economic Forecast Spring 2018

Figure 8
Euro area budget balances
(in % of GDP)



Source: European Commission Economic Forecast Spring 2018

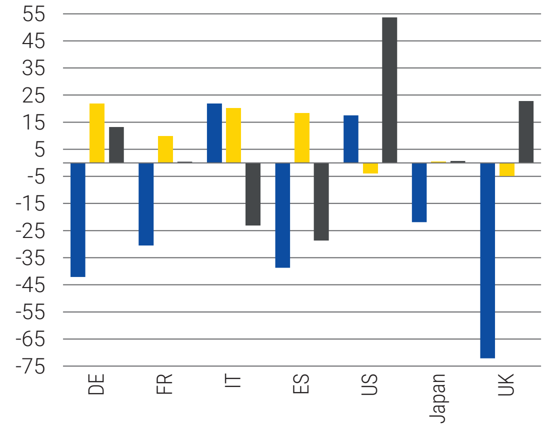
fiscal position failed to improve despite good economic times. The structural primary balance, an imperfect but useful proxy of discretionary fiscal policy, deteriorated. This lack of structural improvement risks leaving insufficient room to manoeuvre when the economy enters the next recession.

Financial environment

Monetary policy normalised further in 2017. In the US, the Federal Reserve increased interest rates three times during the year, and started a gradual and predictable balance sheet reduction in October. At the same time, in the euro area, the ECB reduced its asset purchase programme's (APP) monthly purchase pace first to €60 billion from €80 billion in April, and then to €30 billion from €60 billion in January 2018 while the APP was extended at least until September 2018. Continued monetary support is provided by net asset purchases, the sizeable stock of acquired assets, the forthcoming reinvestments (which will amount to about €12 billion per month on average in 2018), and forward guidance on interest rates. In the UK, the Bank of England also tightened monetary policy and, responding to inflationary pressures, increased rates in November 2017 for the first time since 2007.

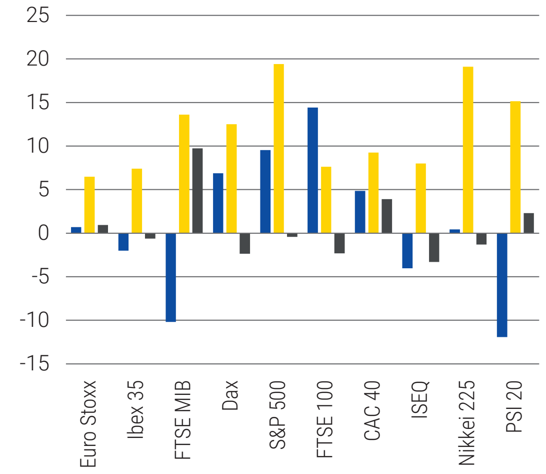
For most of 2017, the reaction of sovereign bond yields to this policy normalisation and strong growth outlook was surprisingly muted. In 2017, 10-year bond yields increased by only 10-to-20 basis points in the four largest euro area markets, and even dropped by about five basis points in the US and UK (Figure 9). This subdued reaction contrasted with the strong performance of most global equity markets (Figure 10). Financial sector stocks contributed largely to these gains, particularly in the euro area where financials exhibited an 11% annual increase, leaving behind a 6% drop in 2016.

Figure 9
Change in 10-year sovereign bond yields
(in basis points)



Source: Bloomberg

Figure 10
Returns on equity markets
(in %)

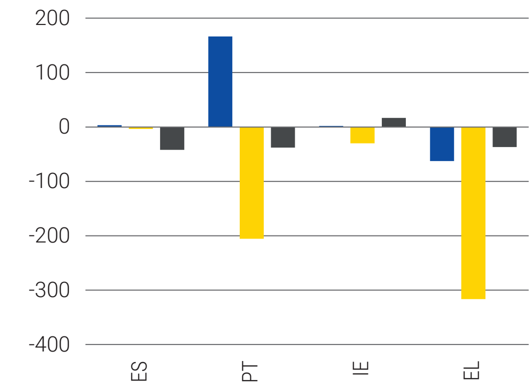


Source: Bloomberg

Sovereign bond yields started to climb materially around mid-December, a movement that continued in early 2018. However, fears of a faster-than-expected recovery of inflation and interest rates, together with abundant short positions in the VIX volatility index, led to a sharp global sell-off in equity markets in early February. The subsequent flight-to-quality flows meant a first pause in bond yields' upward trend. Later in the first quarter of the year, renewed threats of global trade wars further depressed global yields and led to widespread drops in stock market returns.

This volatility has not, however, resulted in any meaningful deterioration in the financing conditions of non-core sovereigns in Europe or in their yield spreads relative to Germany. Non-core countries' 10-year bond spreads have broadly declined over the last few quarters, consistent with a constructive market stance and positive macro, fiscal, and rating developments (Figure 11). Although this spread tightening has been especially intense in Greece and Portugal, where spreads dropped by more than

Figure 11
Change in 10-year sovereign bond spreads vs. Germany
(in basis points)



Source: Bloomberg

"The ESM economic, banking, and strategy teams conduct research to inform the institution's work safeguarding financial stability in the euro area. We examine topics such as banking crises, sovereign ratings, and debt sustainability, and produce papers and host seminars designed to stimulate public policy discussions around these core issues."

AITOR ERCE
Principal Economist

300 and 200 basis points respectively in 2017, the Irish and Spanish spreads have also recently hit new lows since the beginning of the crisis.

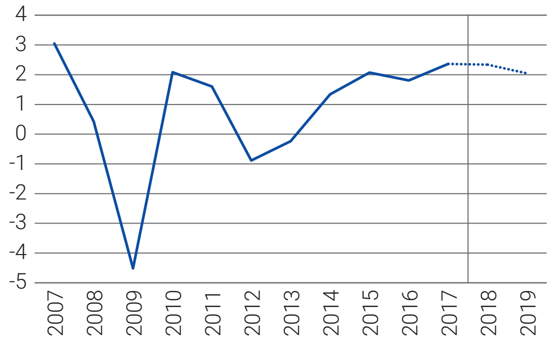
The outlook is positive, but growth is set to slow

The euro area is expected to maintain a steady momentum in 2018 thanks to strong business and consumer confidence, the favourable external environment, ever-accommodative monetary policy, and the revival of investment activity (Figure 12). As the output gap is seen turning positive and the remaining labour market slack vanishing the economy will sooner or later start hitting its capacity limits and growth will eventually slow towards its potential. Unfavourable demographic trends have already resulted in labour shortages in some countries. The external risks to the growth outlook are overall on the downside due to geopolitical tensions and a trade war escalation threat.

Inflation is forecast to gradually pick up speed (Figure 13). As the temporary effects from the oil price swings fade, inflation should mainly reflect underlying fundamentals. The positive output gap and tightening labour markets resulting in higher wage growth should contribute to the gradual pick-up.

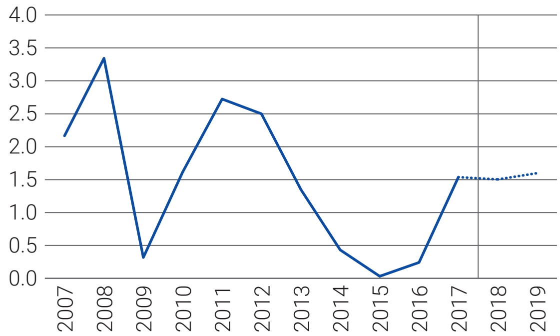
The markets remain highly sensitive to central banks' decisions and communications. Lately, central banks' clear and steady forward guidance, as well as the gradualism of actual policy moves, has meant market participants largely anticipated the monetary policy decisions that have been taken and these did not cause any major financial disruption. In the near term, maintaining these patterns would favour a smooth adjustment of asset prices to the new less-supportive monetary policy scenario and the more promising growth outlook. Nonetheless, in a market environment that has persistently featured stressed valuations, low volatility, and limited liquidity over the last few quarters, a sharp asset repricing remains one of the main risks.

Figure 12
Euro area real gross domestic product growth forecast
(in %)



Source: European Commission Economic Forecast Spring 2018

Figure 13
Euro area inflation forecast
(in %)



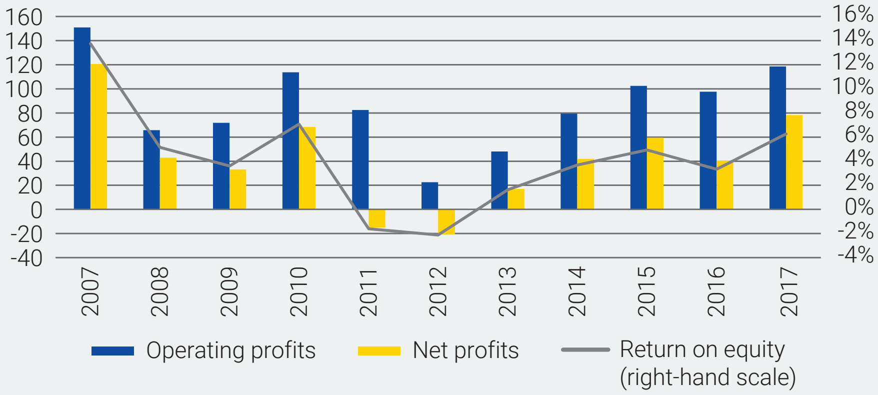
Source: European Commission Economic Forecast Spring 2018

Euro area bank performance improves but outlook uncertain

Euro area banks improved their results in 2017.

In 2017, euro area banks put in their best performance since 2007. Net profit was close to double that of 2016, the clean-up of non-performing loans (NPLs) accelerated with a reduction of more than 15% over the year, and some larger banks finally began to see positive results from painful restructurings. Investors recognised this improved performance through an increase over the year in the average price to tangible book value of the largest euro area banks. In addition, credit default swap spreads, which typically widen when bank default fears grow, narrowed significantly over the same period. Despite putting in their best performance since 2007, euro area banks continue to lag behind US peers in terms of profitability; the final return on equity is still lower than the assumed 8%[2] cost of capital.

Figure 14
Euro area banks' profitability
(in € billion)



Note: The sample of banks includes significant banks supervised by the Single Supervisory Mechanism (SSM).
Sources: Standard & Poor's (SNL Financial), banks' annual reports, ESM calculations

Banks have emerged from the crisis stronger than before.

Banks are much safer than before the crisis. Investors have injected over €700 billion of capital into large euro area banks since the financial crisis began, contributing to capital ratios that are now more than double the level of 10 years ago. Regulation has been strengthened and new institutions established for the supervision (Single Supervisory Mechanism) and resolution (Single Resolution Mechanism) of large banks, which contributed to severing the sovereign-banking nexus. The new resolution framework was tested for the first time in 2017.

However, banks' revenues failed to increase. Lower impairments and litigation costs have until now driven improvements in profitability.

However, reduced loan impairment and litigation costs, rather than an increase in revenues, drove the improvement in profitability. While the reduction in costs is a positive development, the banking sector did not fully mirror the good performance of the euro area economy. Loan growth was sluggish and net interest income declined slightly, which can partly be explained by the flattening of the yield curve. Income from trading activity increased, but this is a volatile line of business.

Banks need to adapt business models to enhance profitability long-term.

Considerable risk reduction has already been achieved, but legacy issues remain in some countries. The reduction in NPLs is not uniform. A disappointing performance in Greece and Cyprus, where NPLs remain close to their peak at systemically concerning levels, offset progress in other countries, particularly in Italy. At the current pace of reduction, it will take three years for NPLs to return to pre-crisis levels for the euro area as a whole and much longer for Greece and Cyprus. Regulatory efforts to ensure that the financial system is stable are a necessary cost burden for banks, while at the same time, non-regulated and innovative players such as technology

[2] Lower end of the range of EBA estimated cost of capital based on the December 2016 Risk Assessment Questionnaire.

firms are entering the market. Banks need to adapt their business models to develop sustainable profitability from core operations.

Completing banking union and consolidating marginal players are required. The euro area banking sector remains affected by important differences in relevant national legislation. Further efforts in levelling the playing field across banking union should be undertaken. Banking union should be completed according to the roadmap adopted by the ECOFIN in 2016, possibly by further specifying certain elements. Although there is no consensus on the final implementation nor on sequencing and some of the proposals are controversial, issues under discussion include the establishment of a common backstop for the SRF, a European deposit insurance scheme, and the removal of ring-fencing of capital and liquidity at a national level; and on risk reduction, according to the Roadmap, minimum harmonisation in the field of insolvency law, and the building of bail-in buffers sufficient to ensure an orderly resolution. These steps, in addition to the risk-reduction measures already introduced and the measures included in the Action Plan to tackle non-performing loans in Europe, would enable banks to better operate across borders within the union, further reduce linkages between banks and sovereigns, and encourage cross-border consolidation and the elimination of marginal players.

Banks need to be able to operate across borders.

Programme country experiences

Ireland sustained its remarkable economic recovery in 2017. Robust economic growth helped reduce both the budget deficit and public debt. Favourable market access enabled Ireland to repay its remaining loans to the IMF, Denmark, and Sweden. Irish banks maintained sufficient capital and liquidity buffers, and exhibited profitability ratios above the euro area average. The economic cycle is, however, approaching its peak. Supply-side bottlenecks could constrain growth if not addressed. NPLs remain stubbornly high. Brexit and changes to the international tax and trade environment represent sizeable external risks.

Real GDP growth of 7.8% meant Ireland was one of the fastest-growing economies in the EU in 2017. But multinational corporations' activities inflated the GDP figure. Their volatile export, import, and investment activities mean that these components are now unreliable measures of Irish domestic economic activity. Growth of close to 4% in modified domestic demand, a measure that removes the distorting activities of multinational corporations, captures Ireland's performance more realistically. Ireland's unemployment rate, at 6.1% in March 2018, is the lowest it has been since 2008 and full-time equivalent employment growth reached 4% in 2017. But labour market tightening coupled with insufficient housing availability represent supply-side constraints that could hamper future growth. External risks from Brexit are sizeable, while changes in the US corporate tax regime could weaken Ireland's attractiveness as a foreign direct investment destination.

Consumer price growth returned to positive territory during 2017, but inflation remained subdued at 0.3%. Housing rental increases, driven by urban property shortages and higher energy prices, boosted inflation. The British pound depreciation led to reduced prices for food and furniture, items heavily imported from the UK, and weighed on inflation.

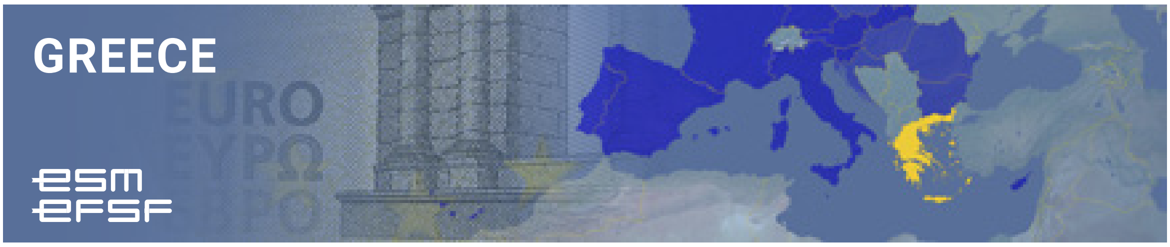
Ireland recorded its fourth consecutive primary budget surplus in 2017. Bank asset sales and some dividends from a bank liquidation facilitated the transition of government finances into a surplus in cash terms for the first time since 2006, and reduced the government debt-to-GDP ratio to around 68%. Revenues from all tax categories increased, with better-than-expected corporate tax returns the main source of the fiscal outperformance. The large contribution of a small number of firms to total corporate tax returns increases the volatility of this revenue stream. Growth in income tax and value added tax receipts was slightly below projections despite robust employment and consumer spending growth. Within-year supplementary expenditure increases exploited the use of available fiscal space and exacerbated the procyclicality of the 2017 budget.

Ireland enjoyed favourable market access during 2017. Total issuance reached €16.2 billion, with a weighted average maturity of 12.4 years and weighted average yield of 0.89%. The larger-than-expected issuance was due to the early repayment of IMF and bilateral loans. These issues increased the debt stock eligible for ECB purchases, eased scarcity concerns, and facilitated an increase in purchases towards the level implied by Ireland's capital key. All credit rating agencies assign Irish debt an A rating. Fitch and Moody's upgraded Ireland's rating during 2017 to A+ and A2, respectively.

Irish banks showed further signs of recovery thanks to strong economic growth and healthy investor appetite for Irish assets. Domestic Irish banks were well capitalised, with capital well above the regulatory minimum. Reduced loan provisions and higher net interest margins increased profitability ratios to slightly above the euro area average. The government successfully sold a 28.8% stake in Allied Irish Bank (AIB) in the market at the end of June, and raised €3.4 billion. However, some vulnerabilities persist. Costs remained high and legacy issues weighed on earnings. Despite banks' efforts, the NPL ratio remained elevated at 10.4% as per the European Banking Authority (EBA) at end-December 2017. Banks face additional challenges from Brexit, regulatory changes, and monetary policy normalisation. They also need to boost digitalised banking capacity.

Under its Early Warning System, the ESM's monitoring shows limited risks for Ireland in meeting its loan service repayments. However, Ireland faces a number of internal risks as the economy approaches the peak of the economic cycle, while external risks are ever-present in such an open economy. These risks warrant the accumulation of fiscal buffers and the close monitoring of Ireland's macroeconomic and financial market dynamics.

GREECE



Greece returned to financial markets in 2017, supported by economic growth and successful reform implementation under the second and third reviews of the ESM programme. Despite strengthened market confidence, the Greek economy faces a difficult economic and financial environment. Greece must address remaining challenges before the programme concludes to ensure that it can build upon its significant programme achievements in the post-programme period.

In 2017, Greece made substantial progress in implementing reforms under the ESM programme, which aims at restoring fiscal sustainability, safeguarding financial stability, boosting growth, competitiveness, and investment, as well as fostering a modern state and public administration. The government also continued clearing arrears using ESM funds and its own resources, and thereby provided direct support to the real economy. The officially recorded stock of arrears, including tax refunds, stood at €3.3 billion at the end of 2017, the lowest level since December 2014.

Following successful policy implementation in the second and third reviews, the ESM governing bodies approved financial assistance of €15.2 billion between July 2017 and March 2018, of which €3.1 billion was allocated to arrears clearance. As a result, €45.9 billion[3] of the up-to-€86 billion programme envelope was disbursed since the initiation of the programme, with, however, just €43.9 billion currently outstanding as Greece prepaid €2 billion in February 2017 related to the redemption of contingent convertible bonds (CoCos) from a bank recapitalisation in which it used ESM funding. Up to €39.1 billion is available until the programme ends in August 2018. Part of this amount should be disbursed in the final programme review, while the rest might be used as part of possible debt measures to be decided by the end of the programme.

For the first time since 2006, the Greek economy grew for four consecutive quarters in 2017, supported by the completion of the second review in June, which helped stem uncertainty and ease market conditions. Economic activity rose by 1.4% in 2017, as increasing investment compensated for declining net exports and government consumption, while private consumption remained largely stable. The European Commission's spring forecast predicts that GDP will increase by 1.9% in 2018 and 2.3% in 2019, and that the current account deficit will narrow to 0.4% and 0.5% of GDP, respectively, from 0.9% of GDP in 2017.

Greece outperformed the ESM programme fiscal targets by a wide margin for the third successive year. According to Eurostat, the primary surplus reached 4.0% of GDP in 2017. This translates into a surplus of 4.2% in programme terms, which exceeds the 1.75% target by 2½% of GDP. The 2015 and 2016 fiscal reforms supported revenue growth, although lower-than-envisaged public investment also boosted the surplus. The authorities legislated additional fiscal measures for the post-programme period as part of the second review to provide further safeguards that the 3.5% of GDP medium-term primary surplus target will be reached. These measures complement existing reform packages by, most notably, adjusting pensions to the new rules as of 2019 and by broadening the personal income tax base as of 2020 if not pulled forward. Additionally, but contingent on the achievement of the medium-term primary surplus target, tax reductions and targeted spending for labour market policies, investment, and welfare will underpin growth. Greece has already implemented some welfare measures in 2017, including the roll-out of the social solidarity income scheme.

Government debt remained elevated at 178.6% of GDP in 2017. To address concerns regarding the sustainability of Greece's public debt, the ESM has successfully implemented the short-term debt relief measures agreed by the Eurogroup at the end of 2016 (Please see page 28). The ESM estimates that by 2060, these measures will reduce Greece's debt-to-GDP ratio by around 25 percentage points and gross financing needs by almost six percentage points. According to the Eurogroup, a second set of debt measures could be implemented after the successful completion of the ESM programme, if needed, to restore debt sustainability. This could include, among other measures, an EFSF re-profiling with an extension

[3] This amount does not include the €1 billion that was approved in the third review for arrears clearance and which is expected to be disbursed by mid-June.

of the weighted average maturity and a further deferral of EFSF interest and amortisation payments between zero and 15 years, which should respect the EFSF's maximum programme authorised amount. To take into account possible differences between growth assumptions and actual growth developments over the post-programme period, the EFSF re-profiling would be recalibrated according to an operational growth-adjustment mechanism to be agreed.

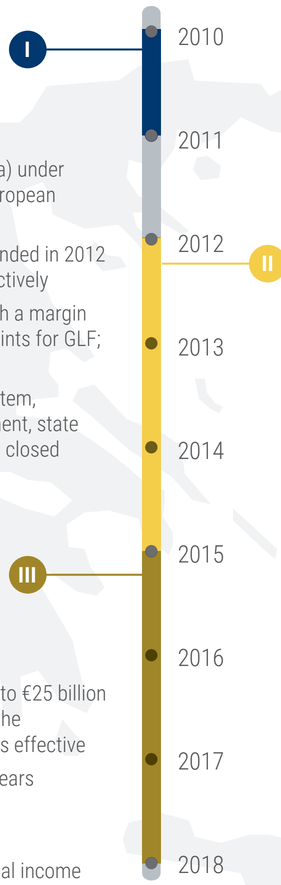
In its first international bond sale since 2014, Greece issued a 5-year bond in July 2017, followed by a liability management operation involving €25.5 billion in November 2017 and a 7-year bond issue in February 2018. The two bond issues raised a total of €4.4 billion at overall favourable rates, helping to build a cash buffer before the programme exit.

The year 2017 also saw the full operationalisation of the Hellenic Corporation of Assets and Participations. This company manages key Greek assets to maximise their financial returns as well as the quality of services that state-owned enterprises and real estate provide to the Greek public. The company's proceeds will assist Greece with debt reduction, as well as support investment and growth.

Greek banks remained stressed due to a very high NPL level of 43.1% of gross loans at the end of 2017. Although banks were meeting targets to reduce the stock, they must step up efforts to meet more ambitious targets over the next two years. In 2017, the government introduced important legislation to assist banks in reducing NPLs to 35.3% by the end of 2019 through an out-of-court workout law and the establishment of an electronic auction platform for the sale of assets. Initial results are, however, below expectations. NPL reduction is a key input into the supervisory stress tests, which determine whether the banks have sufficient capital to absorb losses under different scenarios.

Greece has made significant progress in stabilising its economy. Continuing on this path is decisive for the sovereign to regain stable market access. Timely implementation of outstanding reform commitments will be important to further strengthen the economy and solidify market confidence.

The three financial assistance programmes for Greece



FIRST PROGRAMME

agreed in 2010

Initial programme amount: €110 billion

Total amount disbursed: €73 billion

Lenders: Euro area countries (except Slovakia) under Greek Loan Facility (GLF) managed by the European Commission: €52.9 billion; IMF: €20.1 billion

Grace period and maturity on GLF loans extended in 2012 to 10 and 30 years from 3 and 5 years, respectively

Interest rate: priced with Euribor 3-month with a margin lowered to 50 basis points from 300 basis points for GLF; IMF – around 3.96%

Key areas of legislated reforms: Pension system, healthcare system, public financial management, state budget, public sector benefits, labour market, closed professions

SECOND PROGRAMME

agreed in 2012

Initial programme amount: €164.5 billion

Total amount disbursed: €153.8 billion

Lenders: EFSF: €141.8 billion (including €48.2 billion for bank recapitalisation, €34.6 billion for private sector involvement and bond interest facilities), of which €10.9 billion for bank recapitalisation was not used by the Hellenic Financial Stability Fund (HFSF) and was returned to the EFSF; IMF: €12 billion

Maximum weighted average maturity on EFSF loans extended in 2012 to a maximum 32.5 years from 17.5

Interest rate: Guarantee fee cancelled on EFSF loans and some interest payments deferred by 10 years; IMF: between 2.85% and 3.78%

Key areas of legislated reforms: Labour market, income tax, public administration, social protection, health system, public financial management, business environment

THIRD PROGRAMME

agreed in 2015

Total amount committed: up to €86 billion

Total amount disbursed: €45.9 billion

Lenders: ESM: up to €86 billion (including up to €25 billion for bank recapitalisation); IMF: €1.6 billion if the precautionary stand-by arrangement becomes effective

Maximum weighted average maturity: 32.5 years

Interest rate for cash disbursements: 0.95% (early March 2018)

Key areas of legislated reforms: VAT, personal income tax, pension system, corporate and household insolvency law, out-of-court debt workout, sales and servicing of loans (NPLs), establishment of independent public revenue agency and independent fund for management, investment and monetisation of state assets, public administration, social protection

> Working in the ESM mission team to Greece is exceptionally challenging, as we operate under intense pressure and very tight deadlines. There is an immense team effort and commitment by all colleagues to ensure that we achieve success for Greece, which makes this time one of the most rewarding of my professional career.

MIKE HESKETH

Principal Banking Expert

ESM cuts interest rate risk for Greece on loans, measures also reduce long-term debt burden

ESM's short-term measures cut the interest rate risk for Greece on its outstanding ESM and EFSF loans.

The ESM projects the measures will decrease Greece's debt burden.

The ESM reduced the interest rate risk on Greece's outstanding ESM and EFSF loans by successfully conducting the short-term debt relief measures for Greece in 2017.

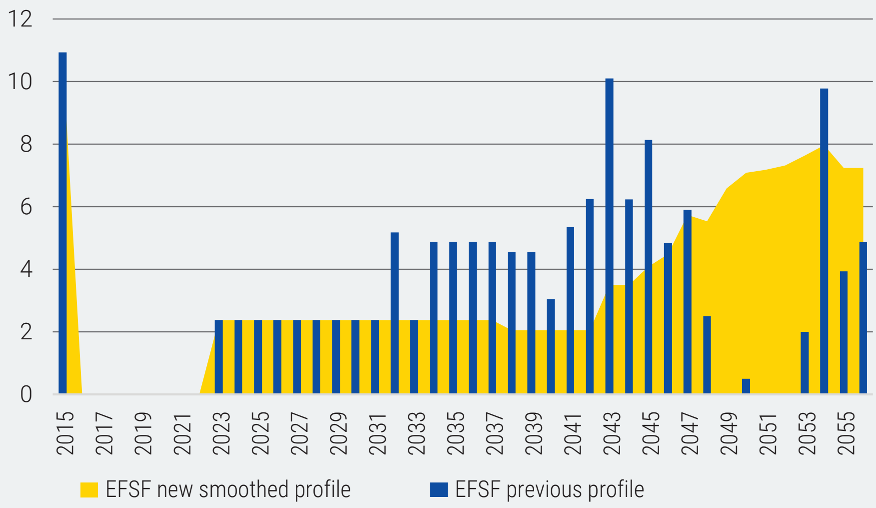
Specifically, the ESM estimates that by 2060 the total package will lower the country's debt-to-GDP ratio by about 25 percentage points and the gross financing needs-to-GDP ratio by around six percentage points. The three short-term measures designed and carried out by the ESM consist of: smoothing Greece's repayment profile; reducing interest rate risk; and waiving the step-up interest rate margin for 2017. The euro area finance ministers mandated the ESM to elaborate these measures in May 2016, endorsing the ESM's proposals the following December. Both the ESM and EFSF Board of Directors adopted them the following month. In their May 2016 statement, the finance ministers also mentioned a possible second set of measures, known as medium-term measures, as well as a contingency mechanism to ensure long-run debt sustainability if an adverse economic situation arises.

Short-term measures

Measure 1: Smoothing the EFSF repayment profile under the current weighted average maturity

The maximum weighted average maturity under the EFSF master agreement was set at 32.5 years. But it dropped to about 28 years after Greece returned bonds to the EFSF in February 2015. The maturity has now been brought back to the maximum of 32.5 years, and the repayment schedule has been re-profiled, to avoid a number of repayment humps in the 2030s and 2040s (Figure 15).

Figure 15
EFSF loans: previous profile vs. new smoothed profile
(in € billion)



Source: ESM

Measure 2: Using the EFSF/ESM funding strategy to reduce interest rate risk without incurring any additional costs for former programme countries

There are three different schemes for the second measure, which focus on locking in the current low interest rates. These bring the largest beneficial effects to Greece in the long term without incurring any additional costs for former programme countries. However, these long-term gains carry some short-term costs.

- **Scheme 1: Bond exchange.** To recapitalise banks, the EFSF/ESM provided loans to Greece worth €42.7 billion during 2012 and 2015. These loans were not disbursed in cash but in the form of floating rate notes. The ESM has now exchanged those notes for cash, funded through long-term fixed-rate funding instruments. This exchange was neutral for Greek banks and needed their consent for implementation. This scheme significantly reduces the interest rate risk that Greece bears.

- **Scheme 2: Swap operations.** The variability of interest rates associated with an ESM loan can be reduced by swapping floating for fixed interest rates. Fixing the interest rate for part of the ESM loan will provide more certainty and predictability on the future stream of interest rates that Greece will pay to the ESM. The ESM put the swap programme in place, and will continue to be active in the derivatives markets to maintain it.

- **Scheme 3: Matched funding.** The ESM can internally allocate the proceeds of long-term issues exclusively to future loan disbursements to Greece. The ESM may continue to use this scheme in 2018, subject to market conditions.

Measure 3: Waiving the step-up interest rate margin related to the debt buy-back tranche of the second Greek programme for the year 2017

In December 2012, the EFSF provided €11.3 billion for financing Greece's debt buy-back operations. A margin of 2% had originally been foreseen from 2017 onwards but was not charged for 2017. This constitutes a relief for Greece of around €220 million.

Impact of the short-term measures

The bond exchange and the interest rate swaps are providing Greece with the most relief.

The short-term debt measures improve Greece's debt sustainability. When implemented in full, these measures should lead to a reduction of Greece's debt-to-GDP ratio of around 25 percentage points until 2060, according to ESM estimates. It is also expected that Greece's gross financing needs will fall by around six percentage points over the same time horizon. The bond exchange and the interest rate swaps make up the largest part of this reduction. Second-round effects on Greece's refinancing rates would be an additional benefit. However, caution is warranted. The impact of some of the measures hinges on several factors beyond the ESM's control. These include the interest rate environment and the availability of other market participants to conclude some transactions.

The short-term measures are seen reducing the overall debt burden by around 10% of GDP.

From a net present value (NPV) perspective, the short-term measures reduce the overall debt burden by around 10% of GDP. The NPV approach consists of discounting the difference between the future cash flows of EFSF and ESM loans before and after the short-term measures. The discount factor reflects the weighted average cost of financing total Greek debt. The NPV gains increase if the second-round effect of lower market refinancing rates for Greece due to the short-term measures is taken into consideration. The eventual aggregate impact of these measures depends, however, on the size and timing of market transactions and the combination of schemes.

SPAIN

GDP growth in Spain remained well above the euro area average in 2017, mainly due to robust domestic demand and, to a lesser extent, to a positive contribution from the external sector. Uncertainty related to events in the Catalonian region had not exerted a significantly negative economic impact at the national level by early 2018. Strong economic activity and expenditure restraints narrowed the public deficit to 3.1% of GDP in 2017. Spanish banks' financial situation further strengthened in 2017, with the Banco Popular resolution in June not resulting in any losses for taxpayers or depositors.

Spanish GDP grew by 3.1% in 2017, slightly below the 3.3% in 2016, and recorded the highest growth among the large euro area economies. Domestic demand drove growth, and the external sector contributed positively, supported by dynamic export growth. Still, the oil price recovery and a surge in imports were offset by strong tourism activity, and the current account surplus remained stable at 1.9% of GDP. The international debtor position narrowed to 80.8% of GDP but remains high. Harmonised inflation accelerated to 2.0% from -0.3% in 2016, boosted by energy prices.

Strong activity supported substantial job creation, driving unemployment below 17% by year-end, i.e. 10.4 percentage points below its peak in mid-2013. But the labour market recovery is not yet complete. Youth and long-term unemployment rates, despite falling at double-digit rates, are still high, with the temporary employment rate among the highest in the EU.

The general government deficit decreased in 2017, driven by the positive economic cycle and some expenditure restraint. For the year as a whole, the general government deficit complied with the excessive deficit procedure target of 3.1% for 2017. In 2018, the vigorous macroeconomic performance is expected to result in a further deficit reduction. Uncertainty surrounding support in parliament for a budget for 2018 delayed its submission by the government. The draft 2018 budget eventually reached parliament on 3 April. A Draft Budgetary Plan, reflecting the targets and measures included in the draft budget, was submitted to the European Commission and the Eurogroup in late April, together with the stability programme update. Public debt declined marginally to 98.3% of GDP in 2017 from 99.0% a year earlier.

Political events related to Catalonia raised uncertainty towards year-end, but the impact was more subdued than initially estimated. Investor demand for Spanish government bonds remained resilient, although there was some underperformance vis-à-vis the country's non-core peers in the last quarter of the year. The Spanish Treasury successfully completed the annual funding programme. It raised €137 billion in 2017, exceeding its annual €132.9 billion bond issuance target.

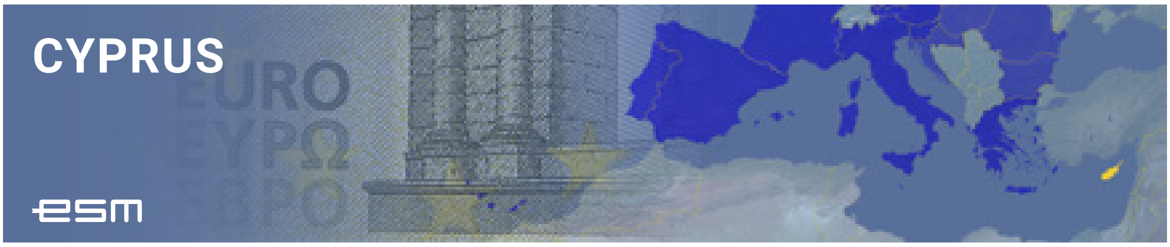
On aggregate, Spanish banks' financial situation continued improving in 2017 despite some limited impact from the resolution of Banco Popular and political uncertainty in Catalonia. Overall, banks remained profitable, capital ratios strengthened, and asset quality improved thanks to the recovery of the economy and the real estate market. Although the NPL ratio for domestic business continued to decline during the year, it remained above the euro area average at 7.8% in December 2017. If one includes the largest banks' business abroad, however, the ratio would be 4.5%, beneath the euro area average of 4.9%. The decrease of credit stock slowed as new lending to the private sector accelerated.

In 2017, Banco Popular was resolved, due to concerns related to its asset quality that triggered a deterioration of its liquidity, and then sold to Banco Santander. The resolution scheme entailed no losses for taxpayers or depositors, and it contributed to strengthening the stability of the banking sector as a whole.

The government, through the Fondo de Restructuración Ordenado Bancaria (FROB), sold 7% of Bankia's shares in December 2017, and the merger between the two remaining state-owned banks was completed in early 2018.

Under its Early Warning System, the ESM continued to assess positively Spain's ability to honour its ESM loan service repayments. In 2017, Spain made two voluntary early repayments of €3 billion in total. Furthermore, the ESM Board of Directors approved on February 2018 a Spanish request to make two additional voluntary early repayments, totalling €5 billion. Nevertheless, given high public debt levels, a credible fiscal strategy, and strong reform momentum are key to reducing the country's vulnerability to adverse shocks.

CYPRUS



Cyprus enjoyed its third consecutive year of growth in 2017, outperforming most of the euro area. Cypriot public finances improved, supported by fiscal prudence and better-than-expected economic developments. But despite ongoing deleveraging, banks remain burdened by NPLs. Reform momentum should not lag, as the reforms are key to underpinning economic strength and enhancing resilience to external shocks.

The Cypriot economy was one of the fastest growing in the euro area in 2017. Annualised GDP grew at 3.9%, mainly led by private consumption and gross fixed capital formation. Investment was volatile, influenced by acquisitions in shipping equipment, but it contributed positively to growth mainly because of large construction projects. Service exports were particularly strong, as Cyprus experienced a record-high tourism season. The Cypriot economy remains dependent on demand from the UK and Russia, in particular in tourism and business services. Economic growth helped to increase the labour force and boost employment. The unemployment rate, however, remains above the euro area average, although it declined to 11.1% in December 2017 from 12.8% in December 2016. A large current account deficit and high private-sector indebtedness are clouding the economic outlook. Consumer price growth turned positive in 2017, after a deflationary period from 2013 to 2016.

Fiscal performance showed impressive improvement. The primary surplus rose to 5.0% of GDP in 2017 from 3.0% in 2016, corresponding to an overall fiscal surplus of 1.8% of GDP in 2017. A favourable economy and prudent fiscal policies drove the better performance. The debt-to-GDP ratio dropped below 100% in 2017 from 107.4% in 2016. To accelerate this decline, the government started to make early repayments on parts of its loans from the IMF and the Central Bank of Cyprus, exploiting beneficial market conditions. The ESM's monitoring of Cyprus' ability to repay, under the Early Warning System, showed that the positive fiscal and economic situation improved the country's ability to meet its scheduled loan service payments. The pace of reforms has, however, slowed, in particular those related to the public and justice administrations.

While NPLs declined further, the banking sector remained vulnerable to shocks. The ample liquidity and the relatively high capital ratios were certainly important mitigating factors, but risks stemming from weak profitability, the high NPL ratio of 43%, and the coverage of 47% that is still slightly below the euro area average could quickly destabilise the system. Although the necessary legal frameworks aiming at reducing NPLs are now in place, they are still inefficient and little used. Instead, banks are more and more in favour of offloading impaired assets from their balance sheets, mostly via debt-to-asset swaps, which deliver NPL reduction in the short-run but leave banks with significant exposure to the real estate sector. Furthermore, new regulatory requirements challenge the banks' outlook.

Positive economic conditions and fiscal consolidation contributed to favourable financial market terms, and the funding costs for the Cypriot government declined further. For instance, the yield on Cyprus' 7-year bond declined by 195 basis points in the year to December 2017. Cyprus was actively involved in lowering its interest payments and smoothing its maturity profile further. The strong economic performance bettered Cyprus' weak credit profile in 2017, reflected in positive outlooks from the rating agencies. Looking forward, any further upgrade will depend on additional improvements in the banking sector, continued solid economic growth, a reduction in the current account deficit, and a decline in the government debt burden.

Cyprus has achieved a solid recovery over the past few years. To boost economic resilience, the country needs to consolidate public finances by further reducing public debt and counteracting the concentration of economic activities by diversifying from the tourism and construction sectors. Despite successive reforms, Cyprus must regain reform momentum to enhance the efficiency of the public sector and judiciary, while supporting fiscal sustainability. The high level of NPLs remains a key vulnerability for banks, which suggests the need for a reform of the insolvency and foreclosure framework, and poses a risk for the economy going forward.

PORTUGAL

Economic activity accelerated in 2017. Strong consumption and investment growth supported the cyclical upswing. Despite fiscal over-performance, prudent fiscal policies must continue to push the high level of debt onto a permanent downward trajectory. While the health of the banking system in Portugal improved and demonstrated clear progress, vulnerabilities remain owing to low profitability and high NPL levels.

In Portugal, GDP growth accelerated to 2.7% in 2017 from 1.6% in 2016 and 1.8% in 2015. The year-on-year quarterly growth rate was particularly strong in the first half of the year compared to the second half. Investment and private consumption primarily drove growth. Net exports' contribution to growth has been negative but small, as import growth triggered by buoyant domestic demand slightly outweighed export growth. The boost from private consumption, however, should gradually fade given high household indebtedness, while any material increase in labour costs would constrain the economy's competitiveness. Labour market developments are positive; the unemployment rate fell to 9% in 2017 from 11.2% in 2016.

Due to the classification of the one-off recapitalisation for Caixa Geral de Depósitos as a capital transfer, the budget deficit in 2017 increased to 3.0% from 2.0% in 2016. However, when excluding this temporary impact, the 2017 fiscal result stands at 0.9% of GDP, below the 1.4% of GDP target set in the 2018 budget. Improved revenue performance and contained expenditure growth drove this outperformance. Government debt is expected to fall to 122.5% of GDP in 2018 from 125.7% in 2017 following the strong fiscal performance and growth acceleration. Fiscal over-performance allowed Portugal to repay more IMF loans early and smooth its debt maturity profile – producing savings from lower debt servicing costs. After the early repayments in 2017 and early 2018, the outstanding IMF loan liability is currently at 187.5% of Portugal's quota (€4.60 billion).

In 2017, S&P and Fitch upgraded Portuguese government bonds to investment grade in view of the positive economic prospects. Portugal's economic performance and the ECB's accommodative monetary policy helped steer the government bond market, shifting the yield curve downwards. At year-end, the 10-year benchmark bond was trading at 1.9% and a 152 basis point spread to its German counterpart. Moreover, the most recent Fitch upgrade to investment grade drove its 10-year spread to Italian peers into negative territory for the first time since the onset of the European sovereign crisis.

The fundamentals of the banking sector significantly improved throughout 2017. The average capital level increased to 13.9% of risk-weighted assets (CET1 ratio) in 2017 from 11.4% at the end of 2016, stemming from capital increases at Banco Comercial Português (BCP), Caixa Geral de Depósitos (CGD), and Novo Banco. The sector's profitability recovered in the first nine months of 2017 compared to the previous year while NPLS visibly declined to a still high 13.3%. Novo Banco, the bank emerging from the resolution of Banco Espirito Santo in 2014, has been partially privatised and is now 75%-owned by the US private equity group Lone Star. The resolution fund is still liable for future losses due to a capital contingent mechanism for Novo Banco.

The Early Warning System suggests no immediate repayment risk, but Portugal still faces challenging debt dynamics. Weaker growth, fiscal consolidation fatigue, or an increase in interest rates would slow the public debt ratio's downward trend as foreseen in the short- to medium-term horizon. In this respect, prudent fiscal policies will be important to ensure a continued decline of public debt. To boost long-term growth and reduce the effects of a shock to the economy, it is important to continue efforts on structural reforms to support investment and productivity and to capture export market share. At the same time, rising house prices need to be closely monitored. In the banking sector, the focus should be on the high level of NPLs and on low bank profitability.

> The purpose of last year's evaluation was to learn lessons for the future. We are now incorporating those lessons by following up on the recommendations made by the High-Level Independent Evaluator. This work will enhance the transparency, effectiveness, and consistency of ESM operations, and strengthen the credibility of future ESM programmes and, ultimately, of the institution itself.

KARI KORHONEN

Senior Advisor, Policy Strategy and Institutional Relations

ESM follows up on independent evaluation recommendations

Independent 2017 evaluation said EFSF/ESM safeguarded euro area financial stability during the crisis.

The 2017 evaluation of the EFSF/ESM financial assistance programmes confirmed that the firewall successfully safeguarded euro area financial stability. It generates confidence through its very existence as a safety net with the capacity to support crisis needs as well as by actually loaning funds to distressed countries in exchange for financial and economic reforms.

And made recommendations to improve ESM working methods and transparency.

An independent and critical appraisal of EFSF/ESM financial assistance is an important objective for euro area member states. The High-Level Independent Evaluator, Gertrude Tumpel-Gugerell, presented this report to the ESM Governors at the 15 June 2017 ESM Annual Meeting. The evaluation looked into different aspects of past programme activities and the post-programme period for five euro area member states. It offers a basis for the ESM to improve the consistency and effectiveness of its processes, make further steps in transparency, and continue delivering its current mandate in cooperation with partner institutions to the best of its ability.

ESM management put together an action plan to address the relevant recommendations.

In alignment with the practices of other IFIs, ESM's management formulated a 13-point action plan to address five of the six recommendations, ensuring a professional follow-up to the evaluation exercise. The sixth recommendation suggests a follow-up by ESM shareholders, not the ESM.

The two workstreams focus on transparency, working methods, and the broader ESM policy framework.

In line with guidance from the ESM Board of Governors, the proposals were grouped in two workstreams. The first addresses transparency and ESM working methods, while the second concentrates on the broader ESM policy framework. The following table summarises the independent evaluator's headline recommendations and the proposed follow-up measures.

Evaluation recommendations and ESM management action plan proposals

Recommendation 1

The ESM should focus on programme credibility and support ownership.

ACTIONS:

- Increase transparency on how the total amount of financial assistance granted can accommodate divergence from baseline programme design.

- Assess the need to modify access criteria for ESM financial assistance instruments.

Recommendation 2
Programme design should have clear objectives and priorities.
ACTIONS:

- Support realistic reform expectations by clarifying priorities for ESM programme design.
- Explore new ways to facilitate consensus building in reform negotiations.

Recommendation 3
The programmes should address financial sector issues upfront, but associated disbursements should be phased, based on progress.
ACTIONS:

- Require a comprehensive financial sector strategy to address the sector's main risks and vulnerabilities.
- Clarify compliance criteria applied to ESM disbursements.

Recommendation 4
The Board should further refine and develop the ESM governance framework.
ACTIONS:

- Further develop guiding principles for ESM financial assistance to improve consistency.
- Establish formal cooperation agreements with key programme partners.
- Strengthen data collection at programme exit to ensure a comprehensive picture on the status and prospects in beneficiary countries.

Recommendation 5
The ESM should enhance programme transparency and evaluability.
ACTIONS:

- Establish a comprehensive public database on EFSF/ESM financial assistance.
- Enhance internal record keeping.
- Assess programme arrangements before exit, to support relevance of future evaluations.

Recommendation 6
ESM Members may clarify the ESM's role in euro area institutional development.
ACTION:

- Member States to conduct high-level discussions on the independent evaluator's conclusion on the need for a broader preventive mandate for the financial stability of the euro area.

The ESM is tackling a first set of measures through a number of cross-departmental workstreams. Proposals related to the policy framework will serve as input for broader discussions on the ESM's activities under the current legal framework. The evaluation findings are already useful for ESM Members' discussions on potential ways to reform the ESM's financial assistance toolkit and role in programme work. ESM Members opted to address the recommendations in steps.

The sixth recommendation on a more preventive operational mandate is linked to the political debate around the future architecture of the Economic and Monetary Union. In this way, the report and the corresponding recommendations are closely connected to the EU and euro area deliberations on the future role of the ESM.

The policy framework will be reviewed once conclusions on possible future mandates are reached.

02 ESM activities

Processing the financial transactions of the ESM

The ESM engages in substantial financial operations every day. These are executed by three different departments. Funding and Investor Relations raises the money to finance lending operations. Investment and Treasury manages the paid-in capital of €80.4 billion[4] and the reserve fund. ALM and Lending monitor the liquidity risk and manage the outstanding loans to programme countries.

The ESM carefully validates and processes all transactions carried out as a result of these operations. This is the task of the Middle and Back Office division. It records, monitors, processes, ensures settlement of, and reports on, every transaction. The Middle Office embeds risk management and control procedures in its transaction processing. The Back Office ensures that securities and financial instruments are bought or sold for the correct amount of money, at the appropriate time, and with the right counterparty. It also transfers the money.

Below is an overview of the tasks that the Middle and Back Office carries out for the ESM's funding, investment, and lending operations. In each case, the Middle and Back Office engages in trade validation, trade matching, and in post-trade activities.

ALM and Lending

The Middle Office participates in the drafting process of lending documents for disbursement. The team verifies the correct recording of loan details in the system and provides invoices for all the countries under a financial assistance programme. The Back Office executes disbursements and subsequently monitors in- and outflows to and from programme countries.

Funding and Investor Relations

Once Funding issues a security, the Middle Office validates the trade. Then the Back Office ensures that the trade details match those of the purchasing institutions. Finally, the Back Office ensures that the trade is correctly delivered.

Investment and Treasury

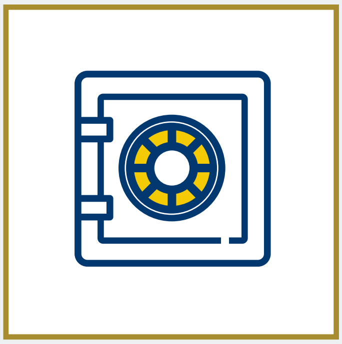
Once Investment initiates a trade, the Middle Office validates it. This means that the Middle Office closely monitors trading activity, making sure details are correctly recorded and investment limits are respected. The Back Office then instructs an external Back Office provider to settle the trade. The Middle Office and the Back Office each have separate post-trading activities to make sure trades are correctly executed.

As part of the Middle Office, the Portfolio Performance team supports Investment and Treasury, the Investment Management Committee, and other functions through performance measurement, appraisal, attribution, and maintenance of benchmark portfolios.

[4] As at 31 December 2017.

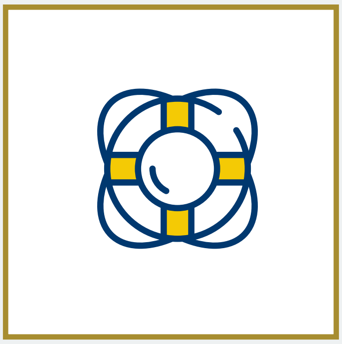
FUNDING

Funding raises the money that the ESM uses to finance its lending operations.



INVESTMENT

Investment manages the paid-in capital of €80.4 billion, the reserve fund, and the ESM liquidity buffer.



LENDING

Lending disburses loans to programme countries.

Coordination

The Coordination team supports large-scale organisational change initiatives. In 2017, Coordination led or contributed to projects related to, for example, the short-term debt measures for Greece, the first ESM US dollar bond issue, and the development of collateral management workflows. Coordination leads the continuous improvement of the annual planning and budgeting cycle, oversees the implementation of the outsourcing policy, and performs tasks such as business analysis and project management.

"In the Middle and Back Office we validate and record ESM funding, investment, and lending transactions, and ensure their correct settlement. As part of the first line of defence, we also monitor risk limits and report on investment portfolio performance. We operate in line with a well-developed internal control framework. In 2017, the Middle and Back Office contributed to the implementation of additional derivative instruments, and the first ESM US dollar bond issue."

MAURICE HICKEY

Head of Middle and Back Office and Portfolio Performance

ALM and Lending activities

- ALM team adapts liquidity management framework to accommodate short-term measures for Greece and the ESM's initial US dollar issue
- Lending team implements second year of three-year programme for Greece (scheduled to end August 2018)
- Spain makes four additional voluntary early loan repayments from 2017 through May 2018
- Cyprus starts repaying its IMF loans early, following ESM approval

Asset and Liability Management

> ALM's role is to measure, monitor, and manage the mismatches between assets and liabilities of liquidity, currency, and interest rates that arise in the normal course of ESM and EFSF business.

In 2017, the ALM team contributed to the design and the implementation of interest rate risk reduction measures for Greece (for more information, see page 28). The ESM and EFSF adapted financial frameworks so that these measures did not alter the interest rates charged to other beneficiary Member States, in compliance with the Eurogroup's guidance.

The ALM team also modified the ESM's liquidity management framework for two significant operational changes: the use of new instruments to hedge interest rate risk for Greece, and the first funding issuance in a second currency, the US dollar, to cover ESM funding needs and expand the investor base. The Funding team assessed and subsequently covered the short-term funding needs that arose from these changes.

Finally, ALM also further enhanced analytical tools and simulation capabilities used to monitor ESM and EFSF exposures and support both the funding and investment teams, as well as the institution's work with programme countries.

Lending

ESM continues financing Greek programme

Under the agreement with Greece reached in August 2015, the ESM is providing financial assistance of up to €86 billion to the country until August 2018. In 2017, the ESM continued to implement the Greek programme according to the terms of the loan agreement.

The ESM made two disbursements to Greece in 2017 totalling €8.5 billion, all in cash. Of these, €6.9 billion was used for debt servicing, while the other €1.6 billion was dedicated to net arrears clearance. The amounts disbursed in 2017 must be repaid from 2034 to 2059.

Table 1
ESM disbursements to Greece

Disbursement	Disbursement date	Loan amount (in € billion)		
		In kind	In cash	Cumulative
1st tranche, sub A, disbursement 1	20/08/2015		13	13
1st tranche, sub A, disbursement 2	24/11/2015		2	15
1st tranche, sub B, disbursement 1	01/12/2015	2.72		17.72
1st tranche, sub B, disbursement 2	08/12/2015	2.705		20.425
1st tranche, sub A, disbursement 3	23/12/2015		1	21.425
2nd tranche, disbursement 1	21/06/2016		7.5	28.925
2nd tranche, disbursement 2	26/10/2016		2.8	31.725
3rd tranche, disbursement 1	10/07/2017		7.7	39.425
3rd tranche, disbursement 2	30/10/2017		0.8	40.225
Total		**5.425**	**34.8**	**40.225**

Source: ESM

The ESM had disbursed €40.2 billion to Greece under the current programme by the end of 2017. This was 47% of the approved maximum of €86 billion for the programme. In March 2018, an additional €5.7 billion was disbursed.

In February 2017, the ESM received an early repayment of approximately €2 billion from Greece, after one bank that had been recapitalised with CoCos returned those funds to Greece in December 2016. This return triggered an early repayment right for the ESM that it decided to exercise.

During the year, the Lending team also contributed to finalising the design and implementation of the short-term debt measures for Greece, which the Eurogroup requested in May 2016 and endorsed in December 2016. The team also continued to contribute to the preparatory work for Greece's exit from the ESM programme, due in August 2018.

Spain makes fifth, sixth, seventh, and eighth voluntary prepayments

In June and November 2017, Spain executed the fifth and sixth voluntary early repayments of loans under its bank recapitalisation programme, for €1 billion and €2 billion respectively, following the ESM Board of Directors' approval. At the end of 2017, the total outstanding amount of the ESM loan to Spain was €31.72 billion. In February 2018, Spain repaid another €2 billion early and the ESM approved an additional early repayment of €3 billion for May 2018.

Spain had previously voluntarily prepaid €1 billion in November 2016, €2.5 billion in July 2015, €1.5 billion in March 2015, and €1.3 billion in July 2014. It also made a scheduled repayment of €0.3 billion in July 2014.

Cyprus starts repaying its IMF loans early following ESM approval

The three-year Cypriot support programme concluded successfully on 31 March 2016, with the ESM disbursing a total of €6.3 billion. The IMF contributed 792 million in special drawing rights, or approximately €1 billion, to the financing of the programme. In May 2017, Cyprus requested that the ESM approve an early repayment of IMF funds, without Cyprus simultaneously repaying the ESM.

According to the loan agreement between Cyprus and the ESM, Cyprus should also make repayments to the ESM if it decides to repay the IMF early. Taking into account the impact on Cyprus' borrowing costs among other things, the ESM's Board of Directors instead approved Cyprus' repayment of parts of its IMF loans without also repaying the ESM.

In addition, the Lending team continued its management of the existing loan portfolio, with a total outstanding amount of €253 billion at the end of 2017.

“Asset and Liability Management played an important role in designing and implementing the short-term Greek debt measures, including hedging and a bond exchange, as we are the first line of defence in managing ESM's liquidity and interest rate risks. We quickly adapted the way we work to deal with specific funding needs and new instruments to stabilise the cost of funding charged to Greece.”

OANA PICINCU

Asset and Liability Management Officer

ESM and EFSF lending fosters budget savings

The ESM and the EFSF provide loans to distressed countries at much lower interest rates than those the market would offer. For Ireland, Greece, Spain, Cyprus, and Portugal, these favourable lending terms have generated budgetary savings, facilitating fiscal consolidation and/or tax cuts.

ESM/EFSF's programme countries benefit from the rescue funds' favourable lending terms.

We estimate these savings by comparing the effective interest rate payments on ESM and EFSF loans with the interest payments these countries would have paid had they covered their financing needs in the market. Estimating total budgetary savings requires two steps.

Budgetary savings estimation is a two-step process.

First, we estimate the direct budget savings per disbursement using the spread between the market rates and the actual ESM and EFSF cost. In short, for every disbursement, the ESM and EFSF rate is compared to the 10-year bond yield, used as a proxy long-term market rate, although the actual refinancing would probably be done at a shorter maturity in periods of stress. For our calculations, we apply a cap of 6.4% on market rates, reflecting the experience of the European crisis where an elevated yield approaching 7% has suggested significant sovereign stress and imminent loss of market access.[5] This maximum rate of 6.4%, used in the ESM calculations, also ensures consistency among countries.

The ESM first compares the spread between market rates and ESM/EFSF loan costs.

Second, we calculate the indirect benefits for the programme countries from the favourable ESM/EFSF refinancing costs. In particular, for each disbursement, the ESM calculates the gains from the previous year's reduced financing needs, making the same market rate assumptions as for direct budget savings.

Second, it calculates the indirect benefits based on the lower ESM/EFSF refinancing costs.

As Table 2 shows, budget savings are significant for all programme countries, especially at the peak of the crisis. Greece has benefited the most, with budget savings reaching 6.1% of GDP in 2017 from ESM and EFSF loans, and another 0.6% savings from the deferred interest, which will only come due after 2022. Cyprus is also benefiting as market rates remain relatively high. The other programme countries also benefited, although to a lesser degree, as the countries have secured market access, successfully exited their programmes, and now themselves enjoy favourable market conditions.

Budget savings are significant for all programme countries.

Table 2
Total budget savings for all programme countries
(in % of GDP)

	2011	2012	2013	2014	2015	2016	2017
Ireland	0.1	0.3	0.3	0.3	0.3	0.3	0.3
Greece		1.6	4.1	5.0	5.3	6.3	6.7
EFSF		1.6	3.7	4.3	4.4	4.8	5.0
Deferred interest			0.4	0.7	0.7	0.7	0.6
ESM					0.2	0.9	1.1
Spain			0.2	0.2	0.2	0.2	0.2
Cyprus		0.0	0.7	1.6	1.9	2.0	2.0
Portugal	0.1	0.4	0.6	0.7	0.7	0.7	0.7

Sources: ESM calculations based on European Central Bank and Eurostat data

[5] The development of market yields preceding the requests for official assistance for Greece (April 2010), Ireland (November 2010), and Portugal (April 2011) support these views. In all three cases, yields rapidly increased once they exceeded these levels. Empirically, the maximum yield at which countries in the euro area have been able to issue over the past eight years has been 6.4%. Therefore, we use this as the relevant benchmark.

Funding and Investor Relations

- ESM issues and taps bonds across the yield curve
- ESM bills in demand despite persistent negative rates
- Debut 5-year dollar bond issue meets good demand, broadens ESM investor base

Funding programme for 2017

The ESM and EFSF raised a combined €61 billion in 2017, the second-largest funding volume in the institutions' history. Of that amount, the ESM raised €11.9 billion and the EFSF €49.1 billion.

Flexibility is of key importance at the ESM, which adapts funding over the course of the year if events require. This was the case in 2017. In December 2016, the institutions announced combined funding volumes of €57 billion for the next year, €17 billion for the ESM and €40 billion for the EFSF. During the year, adjustments were required.

In June, the ESM and EFSF revised the combined funding programme to €61.5 billion. Three factors prompted the ESM to reduce its funding volume by €4.5 billion to €12.5 billion. Spain made an early €1 billion repayment on 14 June; German N-bond (Namensschuldverschreibungen) receipts led to an extra €500 million deduction from the second-quarter target; and favourable liquidity management and shifts in the disbursement schedule for the Greek programme brought about a further €3 billion reduction.

In contrast, the annual funding volume for the EFSF rose in June by €9 billion to €49 billion. In the first months of the year, the demand for very long maturities was better than expected. The funding volume was increased to take advantage of these good market conditions and to allow for a greater volume and faster execution of the bond exchange, part of the short-term measures designed to enhance debt sustainability for Greece.

Following an additional repayment by Spain in November, the ESM subsequently reduced its funding target by another €1 billion and decreased the annual target to €11.5 billion. These final adjustments brought the year's total funding volume for the two institutions to €61 billion.

ESM bond issuance

To raise the required €11.5 billion for the year, the ESM issued across the yield curve, ranging from a tap of a 6-year bond to the issue of a new 30-year bond. This 30-year bond raised €3.5 billion in January and

> Setting up the dollar issuance programme from scratch was a unique opportunity. Many ESM teams provided their expertise to ensure a very successful debut US dollar deal. The programme is part of our ongoing work to expand our investor base, so that we can continue to secure market funding at reasonable rates for the ESM's beneficiary Member States.

SILKE WEISS

Principal Funding Officer

was one of the highlights of the year. Due to investor demand, the ESM tapped that same bond in June for another €1.5 billion, bringing the total raised by the bond in 2017 to €5 billion. This clearly met investor demand for large, liquid supply in the ultra-long end of the yield curve. The ESM completed funding for the year on 14 November with a tap via auction of the 6-year bond.

ESM bill issuance

The ESM maintained its regular short-term funding programme with 3-month and 6-month bill auctions throughout the year. It raised a total amount of nearly €34.32 billion in 23 auctions. The ESM issued all bills at negative rates with the lowest rate recorded at -0.7318% for a 3-month bill issued on 5 December. Demand remained high for ESM bills, with all auctions well oversubscribed despite the negative rates.

ESM launches a dollar issuance programme

At the end of 2016, the ESM announced it would launch a dollar issuance programme. There are two key objectives for dollar issues. First, adding another currency meant entering an additional market, thereby helping to ensure that the ESM always has access to funding. Dollar bonds open ESM issues to a much wider investor base, which not only includes new investors but also additional portfolios of existing investors. The ESM is targeting investors such as central banks, sovereign wealth funds, asset managers, and bank treasuries. The ESM plans to establish a strategic presence in this market, issuing a regular minimum of one-to-two benchmark transactions per year, each of $2-to-$3 billion. The second objective responds to a potential cost advantage. Issuing in dollars may be cheaper than issuing in euros, which means that the ESM may obtain funding at a lower cost.

ESM prepares for first non-euro debt issue

Introducing a new currency was an enormous project for the institution, requiring input from various ESM divisions including Legal, Project Management, Risk and Compliance, Finance and Control, IT, ALM and Lending, and Middle and Back Office. First, the team analysed what needed to be undertaken to issue in dollars. The ESM selected four banks from the ESM Market Group in a competitive process to advise on everything from legal documentation and investor relations to operating models, processes, and hedging strategies.

One major component was the hedging programme. As the ESM only provides loans in euros, any proceeds from dollar bonds would have to be swapped back into euros. Therefore, the hedging programme and the infrastructure behind it had to be implemented and ready before the first issuance. In addition, all the legal documentation relating to the ESM debt issuance programme had to be updated accordingly. To take into account the restrictions on US investors, the ESM created a separate section on the website specifically for these investors. Finally, the ESM constructed its 2017 investor relations marketing plan around the issue, attempting to ensure that investors were fully informed of the upcoming dollar transaction and had all their internal controls completed in time to be able to invest. The ESM identified potential new investors and carried out extensive roadshows across the US and in regions of the world that are primarily interested in dollars, such as Latin America and certain parts of Asia.

Inaugural dollar bond

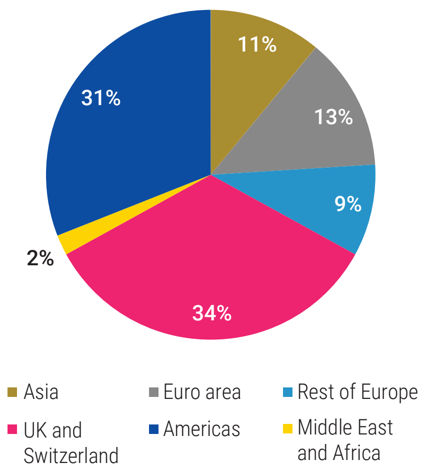
After more than a year of preparation, the ESM priced its inaugural US dollar issue on 24 October 2017. The 5-year bond raised $3 billion, with an order book in excess of $7.25 billion. The issue achieved the objective of widening the investor base by adding a sizeable number of investors, particularly from the Americas, to the ESM name (Figures 16 and 17).

Funding programme 2018

The combined ESM and EFSF funding programme for 2018 was announced in December 2017 to be €51 billion: €23 billion for the ESM and €28 billion for the EFSF. Subsequently, the ESM Board of Governors approved an early repayment by Spain in February and May 2018. Accordingly, the ESM funding target was reduced by €5 billion to €18 billion for 2018.

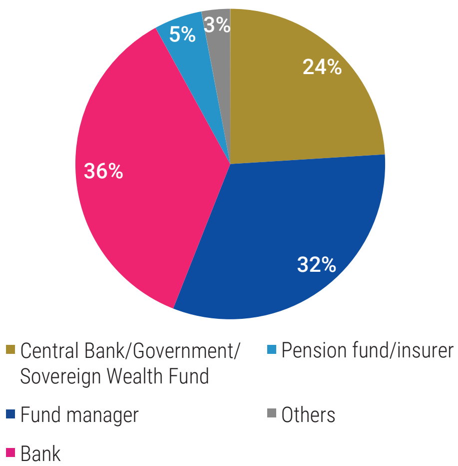
The ESM will continue to issue across the yield curve in response to investor demand via a combination of new issues and taps of existing bonds, through syndication and auction. The ESM will develop the dollar programme to create a regular presence in this market. The ESM will also maintain its N-bond programme, which is aimed primarily at long-term German investors.

Figure 16
ESM debut dollar issue breakdown, by geography



Source: ESM

Figure 17
ESM debut dollar issue breakdown, by investor type



Source: ESM

Major rating agencies affirm ESM's high rating position

Table 3
ESM ratings

Fitch			Moody's			DBRS		
Long-term rating	Short-term rating	Rating outlook	Long-term rating	Short-term rating	Rating outlook	Long-term rating	Short-term rating	Rating trend
AAA	F1+	Stable	Aa1	P-1	Stable	AAA	R-1 (high)	Stable

Note: DBRS ratings are unsolicited.
Sources: The rating agencies named, compiled by the ESM

Investment and Treasury

- ESM profits on investments negative in 2017
- ESM outperforms benchmark
- ESM deploys interest rate and cross-currency swaps

The value of the ESM's paid-in capital continued to increase in 2017, as Latvia and Lithuania, the latest two countries to join the ESM, transferred their respective annual capital instalments of €44.2 million and €65.4 million. As a result, the paid-in capital reached €80.4 billion.[6] When the last instalments from all Members are received in 2027, this total will be €80.8 billion.

After five years of positive performance, the ESM paid-in capital investment recorded a negative return for the first time in 2017 (-€124 million), bringing the accumulated return since 2012 to €1.23 billion as of year-end 2017 from €1.35 billion as of year-end 2016. The negative performance of the paid-in capital is primarily attributable to the negative yield on the assets in which the ESM invests, in particular the negative remuneration on cash balances left with Eurosystem central banks. The rise of European government bond yields, by 15-to-20 basis points in the 2-to-5-year sector, contributed to the mainly unrealised losses, as this pushed the price of fixed-income assets lower. However, the impact was marginal, as the ESM kept its overall interest rate exposure low.

The ESM aimed to optimise the performance of its assets, by adjusting the structure of its investment portfolio on a regular basis, to reduce the impact of negative yields. First, the ESM increased its cash allocation, charged at the Eurosystem deposit facility rate (-0.40% in 2017), to reduce the costs otherwise incurred from investing in short-maturity investments associated with more negative yields. Second, the ESM raised its exposure to the 5-to-7-year part of the yield curve, where returns are slightly higher. Third, the ESM further enlarged its investment universe by adding new issuers and increasing its exposure to non-euro denominated assets, hedged into euros. However, the Investment Guidelines remained unchanged, in the absence of broad-based agreement regarding potential changes. Finally, the ESM lowered the overall sensitivity of the portfolios to interest rate moves, to limit the risk of price depreciation, ahead of a possible normalisation of monetary policy.

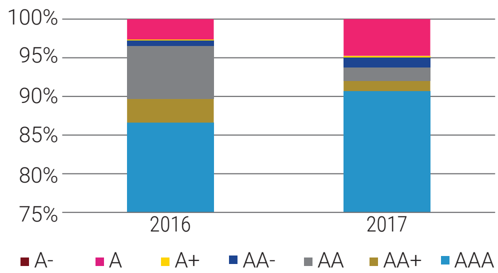
[6] As at 31 December 2017.

While taking these measures, the ESM also kept the overall quality of the paid-in capital at a very high level. Together, cash in Eurosystem central banks and investment in highly rated assets account for: 91% of the paid-in capital, including only assets rated AAA; and 95% of the paid-in capital, including assets rated AA- or higher (Figure 18). Throughout the year, the list of eligible issuers (Figure 19) continued to grow with the inclusion of covered bond issuers and sub-sovereigns based outside the euro area. The expansion of the investment universe is particularly important to help achieve the portfolio diversification objective laid down in the ESM's Investment Guidelines, which require at least 30% of the portfolio, excluding cash, to be invested in issuers located outside the euro area or in supranational entities.

ESM invests in 'green bonds'

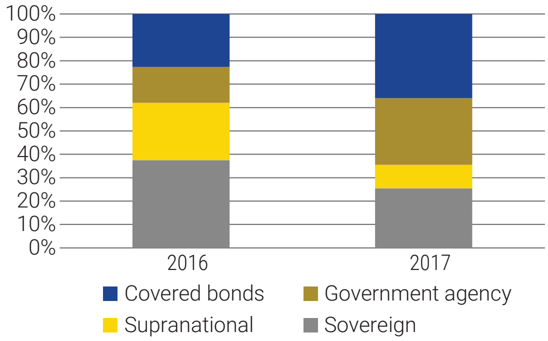
Since 2014, the ESM has been involved in the development of the European Environmental Social and Governance Bond market as an observer and as an investor, when the characteristics and interest rate levels of issued securities were in line with the ESM's investment objectives and the ESM's Investment Guidelines. By allocating some capital to 'green bonds', the ESM intends to support the development of sustainable investments. Since 2014, the ESM's exposure to such assets averaged around €300 million, reaching slightly over €350 million in 2017. The bonds are diversified across a number of euro area issuers and supranational institutions.

Figure 18
Rating distribution of the paid-in capital, by lowest rating, including cash in Eurosystem central banks



Source: ESM

Figure 19
Securities breakdown of ESM paid-in capital, by asset class



Source: ESM

The ESM deploys additional portfolio management tools

The ESM took a key step to enlarge its investment capacity in 2017. It started to use interest rate swaps and cross-currency swaps contracted with commercial banks. These new derivatives tools were added to foreign exchange swaps and forwards, which the ESM has employed since 2015 to hedge short-term foreign exchange exposure. These additional instruments required that the ESM implement a full collateralisation of the potential credit exposures that may arise from these operations and adapt internal risk policies to ensure a prudent implementation and monitoring of these derivatives (see page 51 on use of derivative instruments).

The cross-currency swaps enable the ESM to invest in non-euro denominated assets with long maturities, without the currency risk that would normally be associated with it. They improve the ESM's ability to diversify its exposure to a broader range of high-quality issuers across geographic regions. Thanks to this instrument, the ESM's total exposure in non-euro securities increased progressively, reaching €5.3 billion at the end of 2017. The bulk of the investments, €5 billion, were concentrated in Japanese yen, which offered the most attractive return, with a 50-to-60 basis point yield pick-up over the German yield curve. The remaining positions were spread across three other currencies (US dollar, Danish krone, and Swedish krona) out of a total of nine that are eligible.

The ability to contract interest rate swaps also improves the ESM's capacity to manage the interest rate risk of the paid-in capital. The ESM made only marginal use of these interest rate swaps in 2017, as market conditions did not appear favourable, given that swap spreads reached record lows and interest rates fell for most of the year. The use of these instruments is expected to increase over time, as their importance in managing the ESM's sensitivity to interest rates grows.

The ESM revises and improves its long-term benchmarks

Since inception, the ESM has compared the performance of its portfolios to benchmarks composed of AAA/AA rated euro area government bond indices (0- to 1-year maturity for the Short-term tranche, 1- to 3-year maturity for the Medium/Long-term tranche). Following the revision of the Investment Guidelines in 2016, which formally introduced benchmarking as a return reference, the ESM has reviewed the structure of its benchmarks to improve their representativeness and replicability. In particular, supranational bond indices were introduced and the maturity of the investments was extended to three years for the Short-term tranche and five years for the Medium/Long-term tranche. The objective was also to improve the benchmarks' expected return, while keeping the portfolio's volatility in line with the ESM's Investment Guidelines.

Overall, in mark-to-market terms, the ESM has outperformed its benchmark by, on average, 18 basis points per year since 2012, and 30 basis points in 2017.

> **"Our objective is to safeguard the long-term value of the paid-in capital, while ensuring, at all times, the highest creditworthiness and liquidity of the ESM. To fulfil this mandate, we follow prudent investment policies, use a broad range of financial instruments, and rely on highly skilled professionals."**
>
> SEBASTIEN LEVY
> **Head of Investment and Treasury**

INVESTMENT STRATEGY PROCESS

INVESTMENT STRATEGY

PRESERVES CAPITAL + **REGULARLY ADJUSTS PORTFOLIO STRUCTURE** >

ESM regularly reviews its long-term strategy to ensure smooth adjustment over time

ASSET ALLOCATION

DIVERSIFIES ASSETS + **FOCUSES ON ASSETS WITH AMPLE LIQUIDITY** >

ESM diversifies its investments to ensure only modest impact on any single issuer or security

MARKET IMPLEMENTATION

CALIBRATES TRANSACTIONS TO REFLECT MARKET DEPTH + **CONDUCTS TRANSACTIONS ACROSS VARIOUS CHANNELS** >

ESM adjusts transaction size and trades with a diversified group of eligible inernational counterparties

Risk and Compliance

- Risk and Compliance supported the ESM's first US dollar bond issuance, short-term debt relief measures for Greece, and continued diversification of investments, as part of its role in continually adapting the risk and compliance framework to evolving business needs within the given risk appetite
- Risk and Compliance exchanges best practices with risk departments of other IFIs, hosts internal seminars, and brings in external risk experts, helping further embed the ESM's three lines of defence model

Risk and Compliance at the ESM is built on a best practice framework, consistent with the ESM Treaty and the High Level Principles for Risk Management (HLPRM). (For detailed information, see our website).

In 2017, Risk and Compliance developed the framework to manage the risks linked to the ESM's first foreign currency (US dollar) bond issuance, short-term debt relief measures for Greece, and the diversification into foreign currency investments. These initiatives have required using derivative instruments such as interest rate and cross-currency swaps, in order to manage the related interest rate and foreign currency risks. The ESM uses derivatives only for risk management, not to generate income.

During the year, the Risk and Compliance team further developed appropriate risk methodologies to manage the risks on new debt instruments, capital investment, and related derivative transactions. Based on recommendations from the Basel Committee on Banking Supervision's recommendations, Risk and Compliance co-developed in-house models to monitor credit risk exposures and collateral and liquidity requirements arising from the use of foreign currency swaps and forwards, interest rate swaps, and cross-currency swaps. The team also reviewed ESM risk policies to support the new risk management operations. (For more information, see the ESM financial statements).

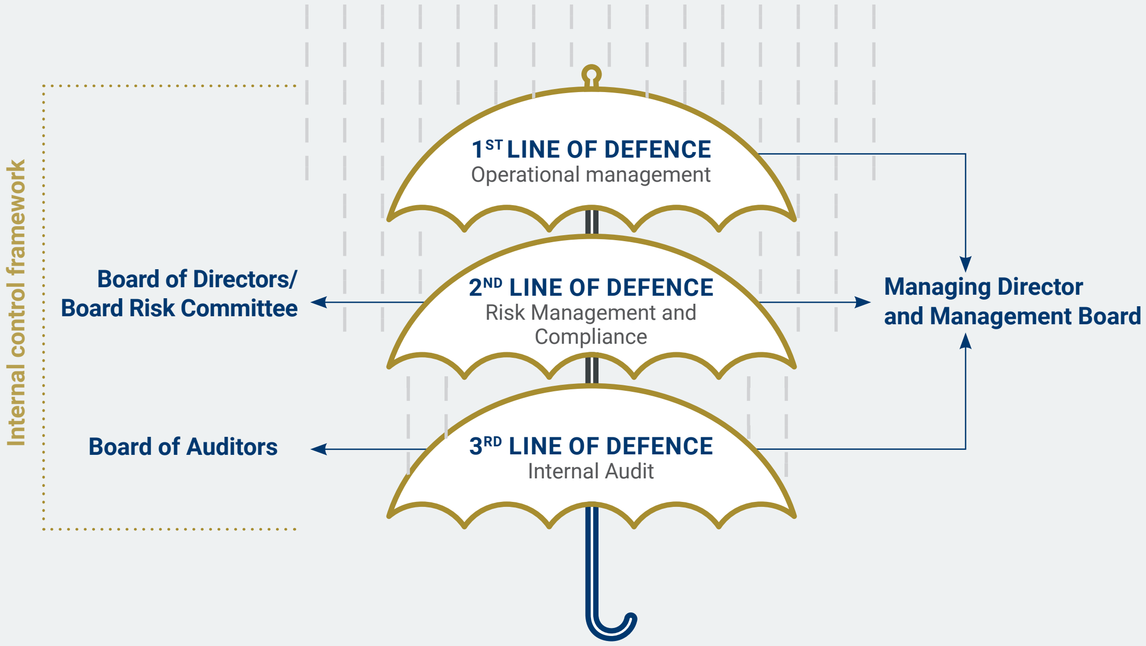
Integrity, confidentiality, and availability of information are critical for the ESM. Risk, together with the information technology (IT) team, continue to build internal capabilities and strengthen partnerships externally to ensure cybersecurity risks are mitigated as much as possible. The ESM's cybersecurity risk management is built on staff awareness, transparency on vulnerabilities that took or could take place, independent risk assessment and evaluations of controls using security best practices, and continuous training on emerging cyber risks and new technologies.

As part of its ongoing effort to develop the institution's risk culture, the Risk and Compliance team brought in speakers and held seminars with all internal teams to reinforce the importance of each staff member's role in risk management and to provide adequate awareness around different risk classes (credit, market, and operational risk).

"The Risk Management team implements and maintains a state-of-the-art risk framework, and thereby contributes to the ESM's long-term financial stability. By defining the risk appetite and limits, we help the ESM to fulfil its mandate to safeguard financial stability in the euro area. The team evaluates risks and ensures that the institution avoids those that are unnecessary and allays those inherent to its mandate, instilling confidence in both its shareholders and investors."

KATERINA ARVANITI
Deputy Head of Risk

THE THREE LINES OF DEFENCE MODEL



The ESM follows the 'three lines of defence' governance model, which sets out clearly drawn lines of authority and appropriate segregation of powers and duties for risk management.

The **first line of defence** consists of business functions and departments with direct responsibility for the day-to-day management of risk. The **second line of defence** is performed by an independent risk management and compliance function, led by the Chief Risk Officer, which oversees the risks assumed by the business and ensures they are appropriately managed and monitored. The **third line of defence** consists of an independent internal audit function, led by the Head of Internal Audit, responsible for providing the Board of Directors with assurance that risk management controls are operating properly and efficiently. Both the Chief Risk Officer and Internal Auditor report directly to the Managing Director, as well as to, respectively, the Board Risk Committee and the Board of Auditors, to ensure their independence.

The Compliance function continued to support the business in line with the ESM Compliance Charter addressing risks in connection with ethical conduct (personal and market), anti-money laundering, corruption prevention, and privacy requirements.

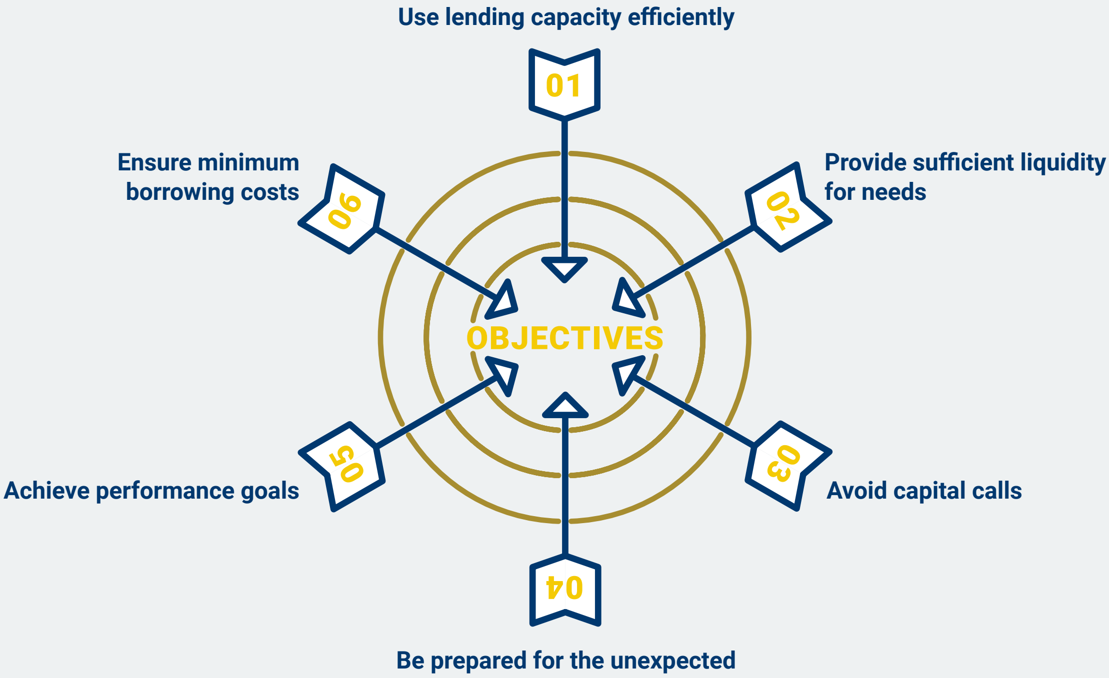
In addition, the ESM participated in the 13th Central Banks Risk Management Conference. Risk and Compliance continues its close collaboration with risk experts in other IFIs to exchange best practices, and regularly participates in the IFI Operational Risk Forum and its European Chapter.

> Safeguarding the integrity of our information systems is a critical ESM security objective. To ensure the institution does not fall victim to cyber-attacks, for example, we must innovate. We are blending traditional security techniques with new technical capabilities, strengthening our internal and external partnerships, adopting new approaches to staff training, and conducting proactive risk management.

JELENA ZELENOVIĆ MATONE

Senior Lead IT Officer, Information Security

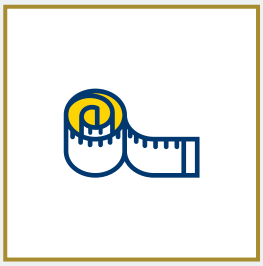
ESM RISK MANAGEMENT OBJECTIVES



FOUR-STEP MANAGEMENT PROCESS

01 RISK IDENTIFICATION

Identification of all material risk exposures, both financial (credit, market, and liquidity risk) and non-financial (operational, reputational, legal, compliance, and political).

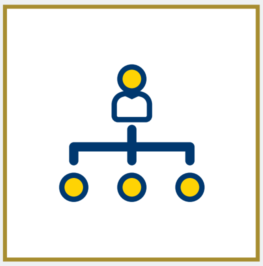


02 RISK ASSESSMENT AND MEASUREMENT

Assessment of identified risk exposures to determine their materiality, based on a combination of quantitative tools and expert judgement.

03 RISK MONITORING AND CONTROL

On-going monitoring and control of material risk exposures, including limit frameworks, key risk indicators, reporting, and escalation.



04 RISK MANAGEMENT

Process of determining and executing appropriate actions to actively manage risk exposures, such as mitigation, transfer, reduction, or acceptance of the risk.

ESM deploys additional derivative instruments to manage financial risks

In 2017, the ESM expanded its use of derivatives to manage risks, specifically interest rate risk and foreign exchange risk. These derivatives enabled the ESM to implement key initiatives over the year:

- the short-term measures to enhance Greece's debt sustainability;

- the first US dollar bond issue, designed to broaden the ESM's investor base; and
- a further diversification of investments in foreign currencies to reduce the concentration of risks in the euro area and help preserve capital in a negative interest rate environment.

The ESM uses certain derivatives to manage risks on non-euro issuance and implement the short-term Greek measures.

The ESM uses derivatives such as interest rate swaps, foreign exchange swaps and forwards, and cross-currency swaps. For US dollar borrowing, for example, the ESM uses derivatives to hedge US dollar cash flows from bond issues back into euros – the currency in which loans to the ESM's programme countries are denominated. Also, one objective of the short-term measures for Greece is to maintain at a low level the long-term financing cost for Greece. The ESM is entering into interest rate swaps to reduce the risk that Greece would have to pay a higher interest rate on its loans should market rates rise.

The ESM applies a prudent framework for such credit exposures.

Managing ESM credit risk on derivatives counterparties is central to ESM risk management, because the derivatives' success in hedging risk depends most particularly on the counterparties' ability to fulfil their obligations. The ESM, therefore, applies a prudent framework for its credit exposures to derivative counterparties. The ESM transacts in derivatives only with creditworthy counterparties including central banks and commercial banks with high credit ratings.

The risk from these exposures is mitigated with collateral.

For operations with commercial banks, all exposures related to derivative instruments are fully collateralised in cash or highly rated securities, on a daily basis, ensuring the ESM's high creditworthiness. For lower-rated bank counterparties, the ESM can contractually request additional collateral to reduce the credit risk associated with the counterparty. This exposure is mitigated by netting and collateral provisions in legal agreements based on internationally accepted standards.[7]

The ESM generally enters into so-called 'two-way' agreements in which the ESM both receives collateral when it has a credit exposure to the counterparty, and delivers collateral to the counterparty when it has an exposure to the ESM. Two-way agreements reduce the liquidity burden that bank counterparties would face if the ESM received collateral but did not deliver it, and enable the ESM to reduce hedging costs from swaps with those counterparties. These lower hedging costs enable the ESM to provide lower funding costs on loans to beneficiary Member States and improve investment returns for shareholders. The ESM follows the Basel Committee on Banking Supervision's standardised approach for measuring the exposure at default linked to derivative transactions traded with banking counterparties.

The ESM has adjusted its liquidity risk framework for the use of derivatives because the ESM may have to deliver collateral to counterparties that have an exposure to the ESM. To ensure this does not present liquidity issues for the ESM, the institution undertakes an assessment of its potential future liquidity requirements and adjusts its funding programme or investments. For instance, the ESM estimates how much collateral, in an extremely adverse scenario, the ESM would have to post to ensure that it has sufficient liquidity, at all times, to cover all its obligations including collateral postings. To conduct these estimates, the ESM uses a range of metrics and in particular the approach developed by the Basel Committee.

Derivative instruments used for investment activities are included in a set of risk metrics employed to monitor the market risk of the investment portfolios. In particular, they are fully integrated in the standard value-at-risk measures to ensure that the overall risk of ESM investments remains fully within the risk appetite defined by the ESM's shareholders.

[7] International Swaps and Derivatives Association (ISDA) Master Agreement and Credit Support Annex (CSA).

Transparency and accountability

As an intergovernmental institution with a public mandate, transparency and accountability are essential for the ESM. Its highest decision-making body, the ESM Board of Governors, comprises finance ministers representing the democratically elected governments of the ESM Members. Furthermore, the ESM is indirectly accountable to national parliaments as some ESM Members also require national parliamentary procedures to approve important ESM decisions.

ESM accountability is further strengthened through the extensive independent oversight provided by the Board of Auditors. The Board of Auditors' annual report to the Board of Governors, together with the ESM management comments in response to the report, are made available to the national parliaments and supreme audit institutions of the ESM Members, the European Parliament, and the European Court of Auditors. As of 2016, the report is also published on the ESM website, together with the ESM management comments, and is thus available to the public.

On 15 June 2017, the ESM published the first evaluation report on EFSF and ESM financial assistance programmes, which the ESM Board of Governors had requested a year earlier. The High-Level Independent Evaluator, Gertrude Tumpel-Gugerell, presented her report to the Board of Governors after nine months of work and consultation. The purpose of the evaluation was to look into past programme activities and draw lessons for the ESM's future work. The report found that the EFSF and ESM had been effective and innovative in providing financial assistance at favourable conditions. Following up on the report, the Board of Governors mandated the ESM to develop a plan to improve its working methods and transparency. Secondly, the ESM Governors noted that the ESM policy framework for financial assistance should be further developed to strengthen the effectiveness of stability support.

In response to a Board of Governors' decision to increase the transparency of programme-related decision making, the ESM has, since 2016, regularly published programme-related Board of Governors' and Board of Directors' meeting documents on its website, such as annotated agendas, summaries of decisions, and background documents. Documents are typically published unless they contain information that could be market sensitive; if disclosure would prejudice the legitimate interests of an ESM Member requesting or in receipt of stability support; threaten euro area stability, disrupt financial markets; or for which special safeguards are needed as per the ESM By-Laws.

In 2017, Transparency International presented the results of its review of the ESM to staff and the public, congratulating the ESM on a number of its practices. It mentioned the ESM's "world-class audit arrangements" and commended the ESM Managing Director, Klaus Regling, for engaging in a regular dialogue with the European Parliament, although he has no legal obligation to do so. The report also praised the increased transparency around programme documents, such as the publication of the Board of Auditors' annual report. Following up on a recommendation made by Transparency International, the ESM decided to further improve its compliance procedures.

The more regular features of our transparency culture also continued during the past financial year. ESM Managing Director Klaus Regling held many public speeches and press conferences in 2017. He was invited to speak before the European Parliament three times. In addition, Management board members and other ESM staff members also spoke at many conferences, seminars, and academic gatherings. There is a continuous dialogue with the media, which results in frequent interviews and TV appearances. This effort seeks to enhance familiarity with the ESM's work across the EU and elsewhere in the world.

> The communications team aims to generate awareness and increase understanding of the ESM's activities, as well as enhance the institution's transparency and accountability. We do this by explaining the ESM's mandate and objectives to the general public in an accessible way through speeches, publications, and press releases, which are distributed through our website, social media, and traditional press coverage.
>
> DEBORAH VAN DAM
>
> **Communications Officer**

The ESM strives to implement environmental, social, and governance best practices within its internal operations

Environment: The ESM is committed to preserving the environment as a sustainable user of resources. It has rolled out several initiatives, and obtained a certificate by the Luxembourg government on the sound treatment of energy sources and the recycling of waste. The ESM also implemented measures to encourage the use of public transport by its employees and energy efficient modes of transportation.

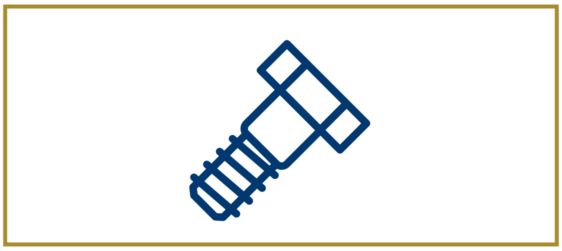
Social: With its internal policies and procedures, the ESM endeavours to ensure that its activities are conducted in accordance with the highest standards of integrity and operational efficiency. The ESM considers its employees to be its most valuable asset and actively supports their wellbeing. The ESM encourages a healthy work-life balance by offering flexible working arrangements to enable an inclusive work environment. The ESM aims to provide equal opportunity to all employees irrespective of their sex, nationality, age, race, culture, education, religious beliefs, sexual orientation, or disability.

Governance: As an institution with a public mandate, accountability and transparency are embedded in the ESM governance framework. The ESM is committed to maintaining a comprehensive system of internal governance and controls, and has undertaken a number of transparency initiatives to ensure that all stakeholders and the general public have a good understanding of the ESM mandate, its work, and decision-making processes. (Please see chapter three for further information).

03 Institutional framework and organisation

The financial assistance toolkit of the ESM

The ESM has a number of financial assistance instruments at its disposal to fulfil its mission, though it has only used two to date. The ESM deploys these tools in exchange for reforms, or 'conditionality', to address the causes of a Member's problems.

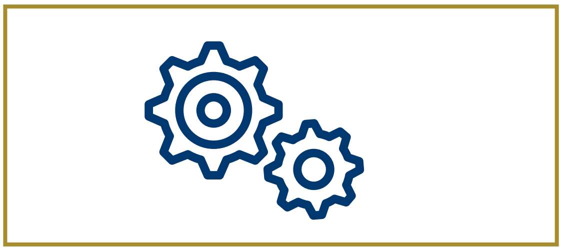


ESM loans

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

Conditional upon: the implementation of macroeconomic reform programmes, negotiated on behalf of the ESM by the European Commission in liaison with the ECB and, where possible, the IMF.

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

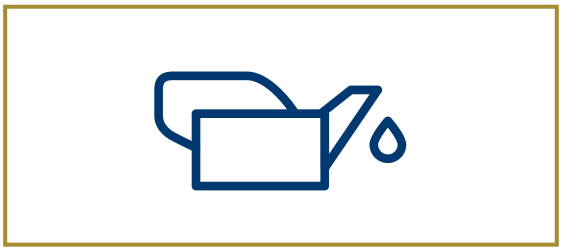


Loans for indirect bank recapitalisation

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

Conditional upon: reforms to financial supervision, corporate governance, and applicable law and regulations on bank recapitalisation, restructuring, and resolution.

Used: in Spain (ESM).



Precautionary credit line

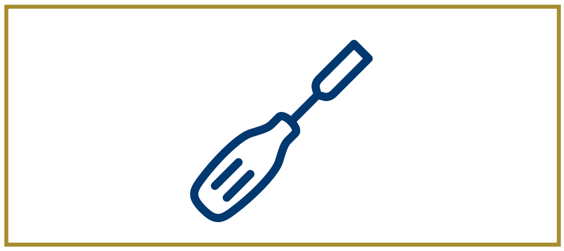
Goal: to prevent crises from emerging or developing, by helping countries whose economic conditions are sound to maintain market access by strengthening the credibility of their macroeconomic performance.

There are two types of credit lines:

A precautionary conditioned credit line is available to an ESM Member whose economic and financial situation is fundamentally sound and meets six specific eligibility criteria, beyond which there is no additional conditionality.

An enhanced conditions credit line is available to an ESM Member whose economic and financial situation remains sound but which does not comply with all the eligibility criteria for the first type. The ESM Member will need to take steps to address weaknesses and avoid market access problems.

Used: no.

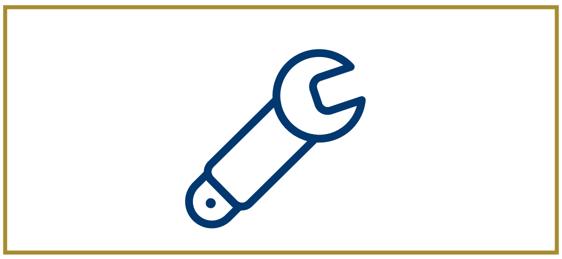


Primary market purchases

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

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

Used: no.

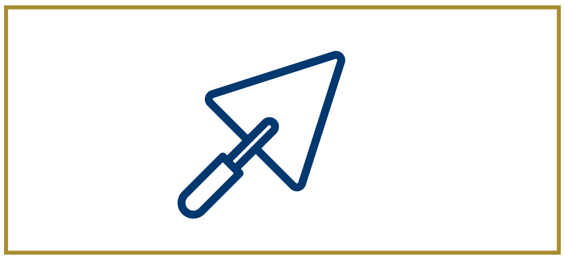


Secondary market purchases

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

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

Used: no.



Direct Recapitalisation Instrument (DRI)

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

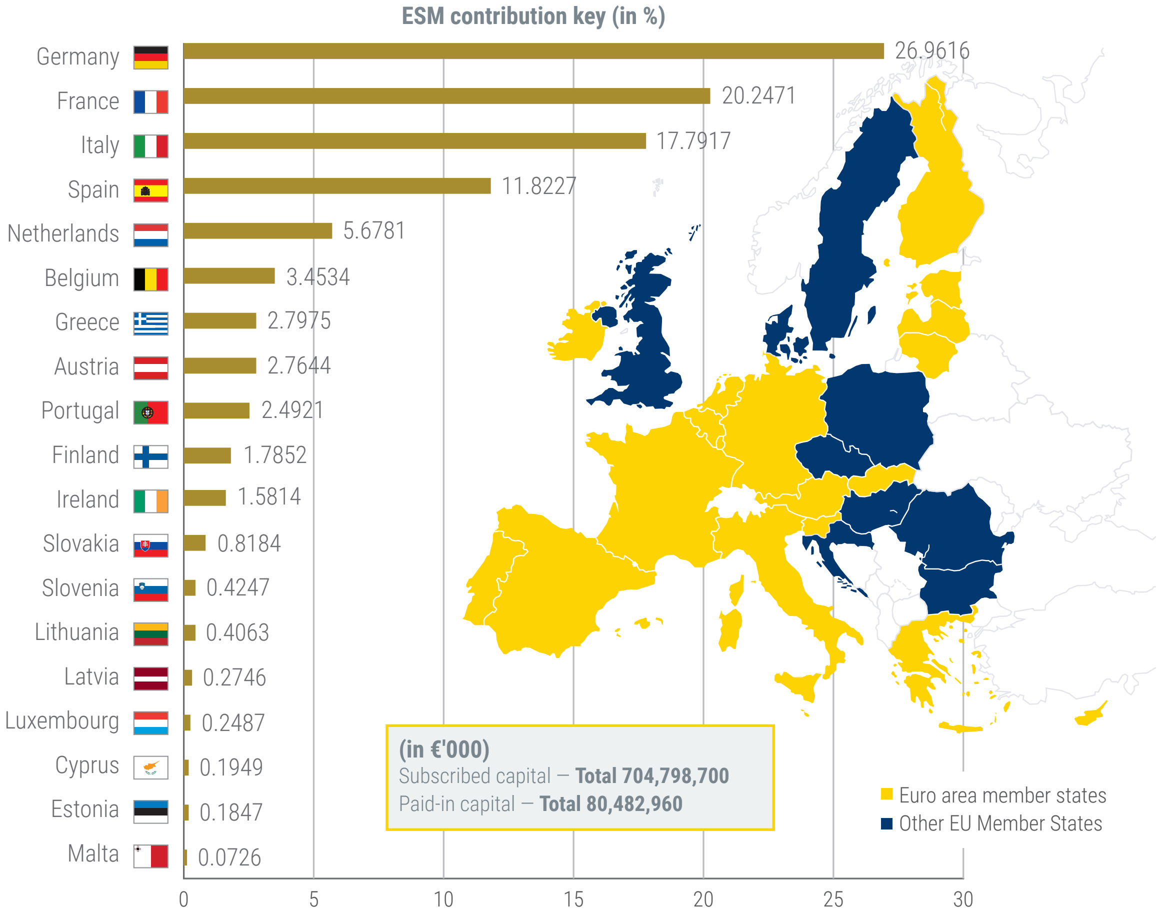
Conditional upon: measures to address the sources of difficulties in the financial sector and the general economic situation of the country. Eligible financial institutions are those that, for example, are unable to attract sufficient capital from the private sector and for which existing burden-sharing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

Used: no.

Governance

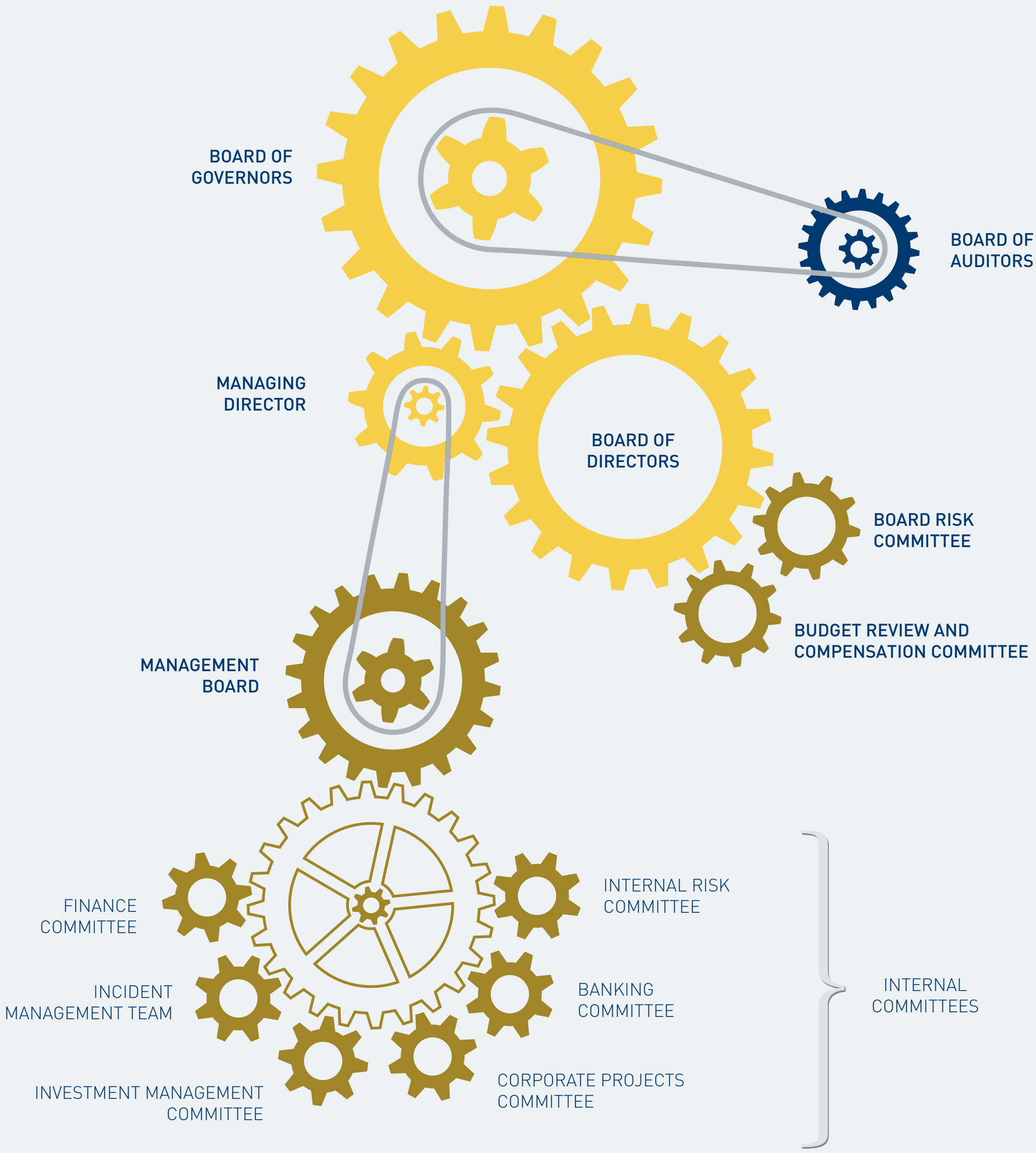
ESM shareholders

The ESM shareholders are the 19 euro area member states that are also referred to as ESM Members. Each Member has contributed to the ESM's authorised capital based on the ESM Members' respective shares of the EU's total population and GDP. The authorised capital amounts to €704.8 billion and is divided into paid-in and callable capital. The paid-in capital currently stands at €80.5 billion.



Notes: As at 30 April 2018.
The accession of new ESM Members is factored into the capital key, reducing the existing ESM Members' contribution keys. Individual nominal capital subscriptions and paid-in capital amounts remain unchanged for the existing ESM Members. In line with Article 42 of the ESM Treaty, ESM Members with GDP per capita of less than 75% of the EU average in the year immediately preceding their ESM accession benefit from a temporary correction mechanism. During this period, the initial capital subscription of the ESM Member benefiting 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. Slovenia, Malta, Slovakia, and Estonia are currently benefitting from temporary corrections, the last of which ends in 2023. Latvia is benefitting from a temporary correction until 2026 and Lithuania until 2027.
Source: ESM

Governance structure



The Board of Governors meets at least once a year and whenever the affairs of the ESM so require. The Board of Directors also meets whenever the affairs of the ESM so require (nine times in 2017), while the Board Risk Committee and the Budget Review and Compensation Committee meet regularly each quarter and additionally when required.

For more information on our governance structure, visit our website.

Board of Governors

Annual Meeting of the Board of Governors

On 15 June 2017, the Board of Governors held its fifth annual meeting at the ESM premises in Luxembourg.

The Managing Director presented the Governors with an overview of key ESM developments and institutional affairs over the past financial year. The High-Level Independent Evaluator, Gertrude Tumpel-Gugerell, was invited to present her evaluation report on the EFSF and ESM financial assistance programmes. Following the discussion of the report, the Board of Governors issued a statement mandating the ESM to follow up on the evaluation report's findings and recommendations.

In addition, the Chairperson of the Board of Auditors addressed the Governors with regard to the Board of Auditor's annual report to the Board of Governors as well as their report in respect of the ESM 2016 financial statements. Furthermore, the external auditor presented its report in respect of the audit of the ESM 2016 financial statements.

On the occasion, the Board of Governors also approved the *ESM 2016 Annual Report* as drawn up by the ESM Managing Director, as well as the appointment of the new external auditor, Ernst & Young S.A., following the completion of the term of the previous external audit firm in line with the ESM By-Laws.

Members of the Board of Governors

PORTUGAL

Mário Centeno

Chairperson of the Board of Governors since 13 January 2018,
Minister of Finance,
Governor since 26 November 2015
(replacing Jeroen Dijsselbloem, Chairperson of the Board of Governors since 11 February 2013)

BELGIUM

Johan Van Overtveldt

Minister of Finance,
Governor since 15 December 2014

GERMANY

Olaf Scholz

Federal Minister of Finance, Governor since 14 March 2018
replacing Peter Altmaier,
Governor since 24 October 2017
replacing Wolfgang Schäuble,
Governor since 27 September 2012

ESTONIA

Toomas Tõniste

Minister of Finance,
Governor since 12 June 2017
replacing Sven Sester,
Governor since 9 April 2015

IRELAND

Paschal Donohoe

Minister of Finance and Public Expenditure and Reform,
Governor since 15 June 2017
replacing Michael Noonan,
Governor since 27 September 2012

GREECE

Euclid Tsakalotos

Minister of Finance,
Governor since 6 July 2015

SPAIN

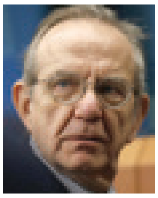
Román Escolano

Minister of Economy, Industry and Competitiveness,
Governor since 7 March 2018
replacing Luis de Guindos Jurado,
Governor since 27 September 2012

FRANCE

Bruno Le Maire

Minister of Economy and Finance,
Governor since 25 May 2017
replacing Michel Sapin,
Governor since 2 April 2014



ITALY

Pier Carlo Padoan

Minister of Economy and Finance,
Governor since 24 February 2014

CYPRUS

Harris Georgiades

Minister of Finance,
Governor since 3 April 2013

LATVIA

Dana Reizniece-Ozola

Minister of Finance,
Governor since 22 March 2016

LITHUANIA

Vilius Šapoka

Minister of Finance,
Governor since 13 December 2016

LUXEMBOURG

Pierre Gramegna

Minister of Finance,
Governor since 4 December 2013

MALTA

Edward Scicluna

Minister of Finance,
Governor since 13 March 2013

THE NETHERLANDS

Wopke Hoekstra

Minister of Finance,
Governor since 26 October 2017
replacing Jeroen Dijsselbloem,
Governor since 27 September 2012

AUSTRIA

Hartwig Löger
Minister of Finance,
Governor since 26 January 2018
replacing Hans-Jörg Schelling,
Governor since 1 September 2014

SLOVAKIA

Peter Kažimír
Deputy Prime Minister and Minister of Finance, Governor since 27 September 2012

SLOVENIA

Mateja Vraničar Erman
Minister of Finance,
Governor since 21 September 2016

FINLAND

Petteri Orpo
Minister of Finance,
Governor since 29 June 2016

Shareholder engagement

As a member-based institution, the ESM strives to maintain strong and effective shareholder relations. The effective shareholder engagement is key for the ESM in fulfilling its mandate while remaining fully accountable to its Members.

In 2017, the ESM organised its fourth annual shareholders day, bringing together ESM staff and 37 representatives from ESM Members' finance ministries with a view to encouraging closer cooperation on ESM-related matters. During the event, participants engaged in panel discussions on a wide range of topics of relevance for the ESM's work, including FinTech solutions for effective debt management, the ESM's first US dollar bond issue, as well as diversity and inclusion as part of the ESM's organisational values.

Over the course of the year, the ESM also participated in various forums where its shareholders are represented to discuss matters of relevance to its mandate, such as the Eurogroup, the Eurogroup Working Group, and the Task Force on Coordinated Action.

In addition, together with the Bridge Forum Dialogue, a Luxembourg-based non-profit organisation that fosters interdisciplinary debates, the ESM organised a conference to celebrate the ESM's first five years, reflecting on its successes and considering its possible future roles. The ESM Managing Director, Klaus Regling, provided an overview of the ESM's past achievements, while the Chairperson of the ESM Board of Governors at the time, Jeroen Dijsselbloem, outlined his vision for the potential future roles of the ESM. The event, titled "The ESM after 5 years: successes, challenges, and perspectives", was moderated by Gaston Reinesch, Governor of the Central Bank of Luxembourg and President of the Bridge Forum Dialogue. It was held on 30 November 2017.

"Our 19 Members place both considerable trust and resources in the ESM. The Corporate Governance team's role is to ensure that we deserve that trust by helping them exercise proper oversight, while facilitating the efficient decision making of the governing bodies and providing adequate expert input from the ESM's professionals. These twin roles underpin the institution's credibility and accountability."

DUŠAN KOVAČEVIĆ
Senior Corporate Governance Officer

Board of Directors

Members of the Board of Directors

CHAIR OF THE MEETINGS
OF THE BOARD OF DIRECTORS

Klaus Regling

ESM Managing Director

BELGIUM

Steven Costers

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

GERMANY

Jörg Kukies

State Secretary, Federal Ministry of Finance, appointed on 9 April 2018
replacing Thomas Steffen, originally appointed on 24 September 2012
Member of the Budget Review and Compensation Committee since 14 May 2018, appointed until 8 October 2020

ESTONIA

Märten Ross

Deputy Secretary General for Financial Policy and External Relations, Ministry of Finance, appointed on 21 October 2013

IRELAND

Nicholas O'Brien

Assistant Secretary General, Department of Finance, appointed on 3 July 2014
Member of the Budget Review and Compensation Committee since 30 September 2014, reappointed until 8 October 2019

GREECE

George Chouliarakis

Alternate Minister of Finance, Ministry of Finance, appointed on 4 February 2015

SPAIN

Fernando Navarrete

Secretary General for Treasury and Financial Policy, Ministry of Economy, Industry and Competitiveness, appointed on 11 April 2018
replacing Emma Navarro Aguilera, originally appointed on 22 November 2016
Member of the Budget Review and Compensation Committee since 14 May 2018, appointed until 8 October 2020

FRANCE

Odile Renaud Basso

Director General of the Treasury, Ministry of Finance and Public Accounts, appointed on 30 June 2016
Member of the Board Risk Committee since 10 February 2017, reappointed until 8 October 2020

ITALY

Gelsomina Vigliotti

Director General for International Financial Relations, Ministry of Economy and Finance, appointed on 15 May 2018
replacing Vincenzo La Via, originally appointed on 8 October 2012

CYPRUS

George Panteli

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

LATVIA

Līga Kļaviņa

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

LITHUANIA

Miglė Tuskienė

Vice-Minister, Ministry of Finance, appointed on 4 March 2015

LUXEMBOURG

Isabelle Goubin

Director of the Treasury, Ministry of Finance, appointed on 19 March 2014
Member of the Budget Review and Compensation Committee since 24 April 2014, reappointed until 8 October 2018

MALTA

Alfred Camilleri

Permanent Secretary, Ministry of Finance, appointed on 8 October 2012
Member of the Budget Review and Compensation Committee since 9 October 2012, reappointed until 8 October 2019
Chairperson of the Budget Review and Compensation Committee since 24 April 2014, reappointed until 8 October 2019

NETHERLANDS

Michel Heijdra

Director International Financial Affairs, Treasury, Ministry of Finance, appointed on 1 February 2018
replacing Hans Vijlbrief, originally appointed on 27 September 2012

AUSTRIA

Harald Waiglein

Director General for Economic Policy, Financial Markets and Customs Duties, Federal Ministry of Finance, appointed on 8 October 2012
Member of the Board Risk Committee since 9 October 2012, reappointed until 8 October 2019

PORTUGAL

Ricardo Mourinho Félix

Deputy Finance Minister and Secretary of State for Finance, Ministry of Finance, appointed on 7 December 2015
Member of the Board Risk Committee since 7 April 2016, reappointed until 8 October 2019

SLOVENIA

Gorazd Renčelj

State Secretary, Ministry of Finance, appointed on 10 February 2017
replacing Irena Sodin, originally appointed on 24 October 2014

SLOVAKIA

Peter Paluš

Head of Financial Unit at Permanent Representation of Slovakia to the European Union, appointed on 22 February 2017
Member of the Board Risk Committee since 8 February 2018
replacing Ivan Lesay, originally appointed on 24 June 2015

FINLAND

Tuomas Saarenheimo

Permanent Under-Secretary, Ministry of Finance, appointed on 12 September 2013

Board of Auditors

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

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

In 2017, the Board of Auditors held seven meetings at the ESM premises. At these meetings, ESM management and senior staff updated the Board of Auditors on ESM activities, the decisions of the ESM governing bodies, and other relevant issues and developments. The Board of Auditors met regularly with the internal audit function, and monitored and reviewed the work and independence of the external auditors. In addition, the Board of Auditors met once with the Board Risk Committee to better understand one another's work. Furthermore, the Chairperson of the Board of Auditors met once with the ESM Board of Directors and attended the Annual Meeting of the Board of Governors to give briefings on the work and conclusions of the Board of Auditors.

Furthermore, the Board of Auditors carried out independent audits of the ESM procurement framework and ESM consultancy expenditures. In fulfilling its role, the Board of Auditors also reviewed the ESM 2017 Financial Statements and the working papers of the external auditor.

In addition to its annual report in respect of the ESM financial statements included in the ESM annual report, the Board of Auditors also draws up an annual report to the Board of Governors which summarises its audit work and its recommendations for the respective year. The Board of Auditors' annual report, together with the ESM management comments in response to the report is made accessible to the national parliaments and the supreme audit institutions of the ESM Members, and to the European Parliament and the European Court of Auditors. The documents are available to the public on the ESM website.

Members of the Board of Auditors

Kevin Cardiff

Chairperson since 21 February 2017
Member since 17 December 2016
Appointed upon nomination by the European Court of Auditors.

François-Roger Cazala

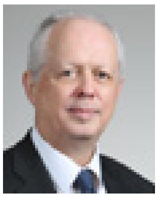
Vice Chairperson since 21 February 2017
Member since 8 October 2016
Appointed upon nomination by the French Supreme Audit Institution.

Günter Borgel

Member since 1 April 2016
Appointed upon proposal of the Chairperson of the Board of Governors.

Andrew Harkness

Member since 8 October 2015
Appointed upon nomination by the Irish Supreme Audit Institution.



Jean Guill

Member since 8 October 2015
Appointed upon proposal of the Chairperson of the Board of Governors.

Note: In line with Article 24 of the By-Laws, two members are appointed upon proposal of the Chairperson of the Board of Governors, two members upon nomination by the supreme audit institutions of the ESM Members based on a system of rotation, and one member by the European Court of Auditors.

Internal control framework

The ESM internal control framework is embedded in the daily operations of the institution and reflects the nature, complexity, and risks inherent in ESM activities. The ESM's internal controls are underpinned by the three lines of defence governance model established by the Board of Directors and are aligned with the principles of the Basel Committee's Framework for Internal Control Systems in Banking Organisations.[8]

The Board of Directors, directly and through the Board Risk Committee, holds periodic discussions with management to review the ESM's internal controls.

The Managing Director, under the direction of the Board of Directors, is responsible for the ongoing implementation of the ESM internal control framework. Assisted by the Management Board, the Managing Director sets a strong tone from the top, demonstrating commitment to integrity and ethical values, and overseeing internal controls across all areas of the ESM. Each year, the Managing Director issues a management report on the state of ESM internal controls to the Board of Directors and the Board of Auditors.

Internal audit provides an independent assurance on the established internal controls and procedures as part of the regular audit cycle. Internal audit independently reviews the entity-level controls on an annual basis.

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

There are inherent limitations to the effectiveness of any system of internal controls, including the possibility of human error or circumvention of overriding controls. Therefore, even an effective internal control framework can provide only reasonable assurance.

The ESM continuously benchmarks its internal control framework against best practices. As such, in 2017 the ESM introduced a mandatory online training on internal controls for all members of staff.

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

"The internal audit team delivers robust reviews of ESM governance, risk management, and its control environment to ensure that the institution continually improves the work essential to achieving its mission. Based upon these reviews, internal audit provides ESM stakeholders with independent, unbiased analyses and recommendations, based upon international standards."

CHRISTOPHE DA SILVA FERREIRA

Senior Internal Auditor

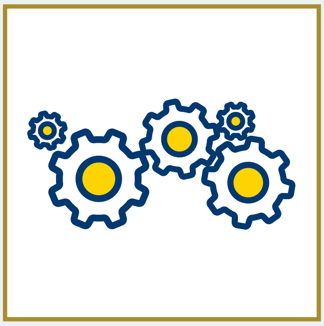
> The ESM annual accounts are a window onto its activities and results. As a public international institution, the transparency and accuracy of the information presented are top priorities. To achieve this, the team follows generally accepted accounting principles and best practice while also reflecting the institution's unique mandate.

FABRIZIO LEUCARI

Lead Senior Officer, Corporate Finance and Budget

ENTITY-LEVEL CONTROLS

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



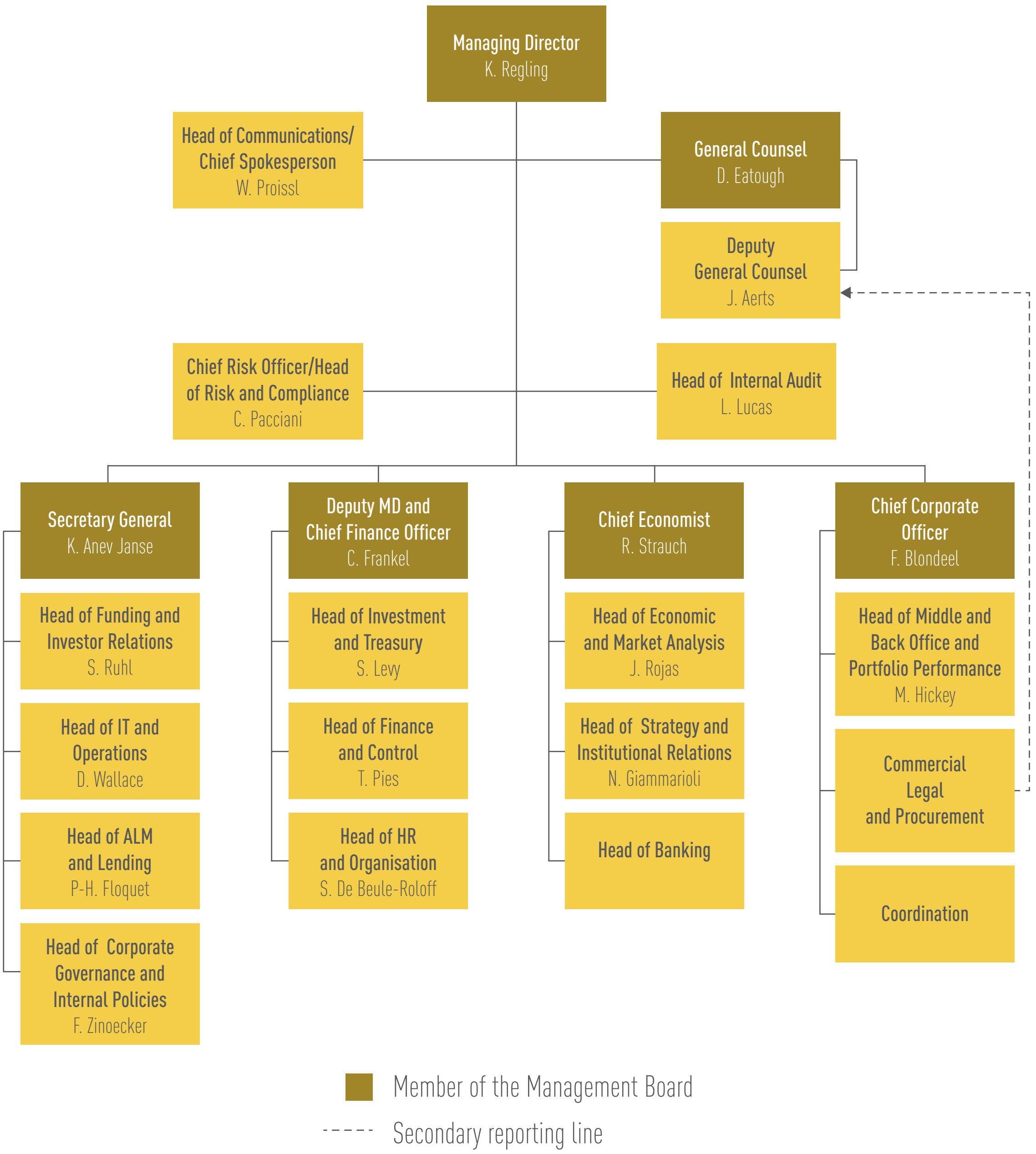
PROCESS-LEVEL CONTROLS

Include operational controls embedded in all key processes and transactions.

INFORMATION TECHNOLOGY (IT) CONTROLS

Include IT general controls over the IT environment, computer operations, access to programs and data, program development, change management, and automated transaction processing controls.

ESM organisational structure



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

5 years of the ESM
October 2017

We hail from 42 countries

ESM has organised and hosted some 150 events, including research seminars, expert conferences, guest lectures, and visitor groups

60% of our staff joined the ESM from the private sector, 40% from public institutions

ESM has disbursed €87 billion for a combined total with the EFSF of €272 billion

We strive to represent our 8 core internal values, balancing flexibility with stability in our daily work

We speak 33 different languages

04 Financial report

Balance sheet

At year-end, the total balance sheet of the ESM was €797.0 billion. Compared to 31 December 2016, the balance sheet increased by €3.9 billion, mainly due to new loan disbursements in 2017. The ESM disbursed €8.5 billion in loans to Greece and received early repayments from Spain for €3 billion and from Greece for €2 billion following the sale of recapitalised NBG bank.

To provide financial assistance to the beneficiary Member States, the ESM relies on its funding activity. In 2017 the total liability in respect of debts evidenced by certificates increased by 4% to €89.2 billion (€85.7 billion in 2016), reflecting the increase in lending activity and in the liquidity buffer.

As of 31 December 2017, the total €80.4 billion of paid-in capital is invested in debt securities and money market instruments, or held in cash.

Unrealised gains or losses resulting from the valuation of the securities portfolio are reflected in the fair value reserve within the equity position of the ESM. As of 31 December 2017, the fair value reserve was €99.1 million, compared to €183.2 million as of 31 December 2016. The decrease in the fair value reserve mainly reflects the reduction of the investment's values on the market compared to the previous year, largely due to changes in interest rates.

Profit and loss account

The ESM recorded a net income[9] of €68.6 million for the financial year 2017, compared to €568.8 million in 2016.

The decrease by €500.2 million is mainly due to negative interest charged on cash and cash equivalents, amounting to €273.7 million in 2017 (nil in 2016). Starting from February 2017, the ESM is being charged a negative interest (-0.40% per annum) on the cash held with national central banks. The lower net income was also significantly driven by the lower net realised result from the sales of debt securities, amounting to €27.2 million in 2017, €259.9 million less than in the previous year.

Furthermore, net interest income on debt securities held in the paid-in capital portfolio decreased by €21.7 million due to fewer investments as well as decreasing yields in the portfolio. The increase of net interest charges on debt issued and on derivatives was fully absorbed by the increase in interest income on loans as the cost of funding incurred by the ESM are charged to the beneficiary Member States.

Operating costs including depreciation of fixed assets were €61.3 million, compared to €54.1 million in 2016, mainly due to additional staff and related overhead costs. The ESM provides certain administrative services to the EFSF, and therefore charges it service fees of €30.9 million, which are recognised as Other operating income. The ESM continues to focus on budgetary discipline and effective cost control.

In 2017, the ESM recorded an extraordinary income of €18.9 million for a payment received from the European Commission following a fine imposed on Spain. The fine was a sanction pursuant to Article 8(1) Regulation (EU) No.1173/2011 which was collected by the European Commission and then assigned to the ESM.

Outlook for 2018

The ESM has actively diversified its investments and continues to look for additional measures to mitigate the impact of the negative yield environment, in line with its guidelines and its mandate. Nevertheless, the persistence of this environment will negatively affect the ESM's net income also in 2018.

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[9] The net income of the ESM is mainly driven by the interest margin on its lending activity and the return on the investment of its paid-in capital. The ESM Pricing Policy defines the different elements of the total cost of a loan.

Balance sheet

As at 31 December 2017 (in €'000)

	Notes	31.12.2017	31.12.2016
ASSETS			
Cash in hand, balances with central banks and post office banks	4	74,288,120	64,922,796
Loans and advances to credit institutions			
(a) other loans and advances	5	369,174	1,514
		369,174	1,514
Loans and advances to euro area Member States	6	76,194,688	72,732,950
Debt securities including fixed-income securities	7		
(a) issued by public bodies		10,971,804	20,986,061
(b) issued by other borrowers		9,918,880	9,476,986
		20,890,684	30,463,047
Intangible assets	8	36	47
Tangible assets	9	4,664	4,189
Subscribed capital unpaid	2.15/15	624,250,300	624,250,300
Subscribed capital called but not paid	2.15/15	175,120	284,800
Prepayments and accrued income	10	820,833	451,483
Total assets		796,993,619	793,111,126
LIABILITIES			
Amounts owed to credit institutions	11	32,600	–
Debts evidenced by certificates	12		
(a) debt securities in issue		89,201,083	85,658,968
		89,201,083	85,658,968
Other liabilities	13	8,488	12,068
Accruals and deferred income	14	789,576	462,731
Total liabilities		90,031,747	86,133,767
SHAREHOLDERS' EQUITY			
Subscribed capital	2.15/15	704,798,700	704,798,700
Fair value reserve	7	99,119	183,194
Reserve fund	2.7.1/16	1,995,465	1,426,701
Profit for the financial year		68,588	568,764
Total shareholders' equity		706,961,872	706,977,359
Total equity and liabilities		796,993,619	793,111,126

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

Off-balance sheet

As at 31 December 2017 (in €'000)

	Notes	31.12.2017	31.12.2016
OFF-BALANCE SHEET			
Commitments	25		
(a) undisbursed loans to euro area Member States		45,774,339	54,274,000
		45,774,339	**54,274,000**
Other items	26		
(a) notional value of interest rate swaps			
- receivable		36,512,000	–
- payable		(36,512,000)	–
(b) notional value of cross-currency interest rate swaps		–	–
- receivable		5,788,261	–
- payable		(5,730,986)	–
(c) notional value of currency swap contracts[(1)]		–	–
- receivable		2,305,628	2,943,375
- payable		(2,048,620)	(2,783,679)
(d) notional value of currency forward contracts		–	–
- receivable		1,363	2,356
- payable		(1,216)	(2,227)

[1] For comparison purpose, 2016 figure has been restated.

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

Profit and loss account

For the financial year ending 31 December 2017 (in €'000)

	Notes	2017	2016
Interest receivable and similar income			
(a) on loans and advances to credit institutions		304	84
(b) on loans and advances to euro area Member States	17	938,764	684,197
(c) on debt securities including fixed-income securities	18	59,759	77,177
(d) on debts issued		95,744	76,204
(e) other	26.1	71,339	4,164
		1,165,910	**841,826**
Interest payable and similar charges			
(a) on cash and cash equivalents	19	(273,744)	-
(b) on loans to credit institutions		(329)	-
(c) on debts issued		(677,873)	(525,862)
(d) on debt securities including fixed-income securities	18	(7,937)	(3,686)
(e) other	26.1	(159,942)	(3,222)
		(1,119,825)	**(532,770)**
Commissions payable		**(26)**	**(11)**
Other operating income	20	**37,709**	**26,737**
Net profit on financial operations	21	**27,174**	**287,073**
General administrative expenses			
(a) staff costs	22	(31,166)	(27,331)
- wages and salaries		(22,841)	(20,213)
- social security		(8,325)	(7,118)
of which relating to pension		(7,074)	(6,084)
(b) other administrative expenses	23	(29,019)	(25,746)
		(60,185)	**(53,077)**
Value adjustments in respect of intangible and tangible assets		**(1,099)**	**(1,014)**
Extraordinary income	24	**18,930**	**-**
Profit for the financial year		**68,588**	**568,764**

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

Statement of changes in equity

For the financial year ending 31 December 2017 (in €'000)

	Subscribed capital	Fair value reserve	Reserve fund	Profit brought forward	Profit for the financial year	Total
At 1 January 2016	704,798,700	127,703	697,326	-	729,375	706,353,104
Allocation of the profit of 2015	-	-	-	729,375	(729,375)	-
Allocation of profit brought forward to the reserve fund	-	-	729,375	(729,375)	-	-
Profit for the financial year	-	-	-	-	568,764	568,764
Change in fair value reserve	-	55,491	-	-	-	55,491
At 31 December 2016	704,798,700	183,194	1,426,701	-	568,764	706,977,359

	Subscribed capital	Fair value reserve	Reserve fund	Profit brought forward	Profit for the financial year	Total
At 1 January 2017	704,798,700	183,194	1,426,701	-	568,764	706,977,359
Allocation of the profit of 2016	-	-	-	568,764	(568,764)	-
Allocation of profit brought forward to the reserve fund	-	-	568,764	(568,764)	-	-
Profit for the financial year	-	-	-	-	68,588	68,588
Change in fair value reserve	-	(84,075)	-	-	-	(84,075)
At 31 December 2017	704,798,700	99,119	1,995,465	-	68,588	706,961,872

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

Statement of cash flows

For the financial year ending 31 December 2017 (in €'000)

	2017	2016
Cash flows from operating activities:		
Profit for the financial year	68,588	568,764
Adjustments for:		
Value adjustments in respect of tangible and intangible assets	1,099	1,014
Changes in:		
Tangible and intangible assets	(1,563)	(2,302)
Other liabilities	(3,580)	2,297
Accrued interest and interest received	(1,066,941)	(935,683)
Prepayments	(274,121)	(176,539)
Accruals and deferred income and interest paid	923,222	409,714
Out of which:		
Interest received	971,712	978,744
Up-front service fee received	51,500	51,500
Interest paid	(647,877)	(444,618)
Net cash provided by operating activities	**22,039**	**452,891**
Cash flows from investing activities		
Change in debt securities including fixed-income securities	9,488,288	5,027,419
Change in loans and advances to credit institutions	(367,660)	185,000
Net loans disbursed during the year	(3,461,738)	(9,287,368)
Changes in amounts owed to credit institutions	32,600	-
Net cash provided/used in investing activities	**5,691,490**	**(4,074,949)**
Cash flows from financing activities		
Payment of capital	109,680	109,680
Changes in debt securities in issue	3,542,115	13,604,123
Net cash provided by financing activities	**3,651,795**	**13,713,803**
Net increase/decrease in cash and cash equivalents	9,365,324	10,091,745
Cash and cash equivalents at the beginning of the financial year	64,922,796	54,831,051
Cash and cash equivalents at the end of the financial year	**74,288,120**	**64,922,796**

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 ratification of the ESM Treaty by the then 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 2017 to 31 December 2017, while comparative figures cover the period from 1 January 2016 to 31 December 2016.

On a proposal from the Managing Director, the Board of Directors adopted the financial statements on 27 March 2018 and authorised their submission to the Board of Governors for approval at their 21 June 2018 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 a new instrument, the Direct Recapitalisation of Institutions.

1.2. Overview of the pricing structure of the financial assistance programmes

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

- Base rate – the cost of funding incurred by the ESM, derived from a daily computation of the actual interest accrued on all bonds, bills, and other funding instruments issued by the ESM.
- Commitment fee – the negative carry and issuance costs incurred in the period between the funding by the ESM and the disbursement to the beneficiary Member State, or for the period from the refinancing of the

relevant funding instrument until its maturity. The commitment fee will be 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. The specific elements are detailed in the ESM Pricing Policy.

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 countries, 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 billion. The loans were provided to Spain's bank recapitalisation fund, Fondo de Restructuración Ordenado 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 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 government. 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 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 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 billion, which was approved by the ESM Board of Directors on 26 October 2017 and the repayment took place on 16 November 2017.

By 31 December 2017, Spain had, in total, repaid €9.6 billion of its financial assistance. All repayments were made in cash.

The outstanding nominal amount of loans granted to Spain as at 31 December 2017 is €31.7 billion (refer to note 6).

1.4. ESM financial assistance to Cyprus

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

The agreement on the macroeconomic adjustment programme led euro area members to decide on a financial assistance package of up to €10 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 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 billion on 13 May 2013, and transferred the second in the amount of €1 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 2017 is €6.3 billion (refer to note 6).

1.5. ESM financial assistance to Greece

The EFSF financial assistance programme for Greece expired on 30 June 2015. On 8 July 2015, the Greek government submitted a request for financial assistance to the Chairperson of the ESM Board of Governors. On 13 July 2015, the euro area ministers of finance 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 finally approved a new programme on 19 August 2015. The programme focuses on four key areas: restoring fiscal sustainability, safeguarding financial stability, boosting growth, competitiveness and investment, and reforming the public administration.

At the same time, the ESM Boards of Governors and Directors approved the financial assistance facility agreement (FFA) with Greece on 19 August 2015. The ESM will provide Greece with up to €86 billion in financial assistance over three years. The precise amount of ESM financial assistance will depend on IMF's participation in the programme and on the success of reform measures by Greece.

The funds available under the FFA are 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 has committed to a series of far-reaching economic reforms.

On 20 August 2015, the ESM approved the first tranche of €26 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 billion in cash to Greece. This was the first disbursement under the first sub-tranche, of €16 billion, to be used for budget financing and debt servicing needs. The second sub-tranche, of €10 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 billion in cash to Greece as the second disbursement under the €16 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 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 billion to Greece as the third and final disbursement under the €16 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 is a bond exchange, where floating rate notes disbursed by the ESM to Greece for bank recapitalisation will be exchanged for fixed coupon notes. The second scheme allows the ESM to enter into swap arrangements to reduce the risk that Greece will have to pay a higher interest rate on its loans when market rates start rising. The third scheme, which will be implemented in 2018 will entail issuing long-term bonds that closely match the maturity of the Greek loans, and implies the ESM charging a fixed rate on part of future disbursements to Greece.

On 20 February 2017, the ESM received a loan repayment of €2 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.

The outstanding nominal amount of loans granted to Greece as at 31 December 2017 is €38.2 billion (refer to note 6).

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[10] to exercise its judgement in applying the ESM's accounting policies. Areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the financial statements are disclosed in Note 2.3.

For comparison purposes, some of the 2016 figures presented in the off-balance sheet have been restated.

2.2. Basis of measurement

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

2.3. Use of estimates

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

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

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

[10] 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.

No value adjustment was required as at 31 December 2017 and 2016, thus none has been recorded.

2.4. Foreign currency translation

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

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

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

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

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

2.5. Derivative financial instruments

The ESM uses derivatives for risk management purposes only. Derivative transactions such as currency swaps and forward contracts are used to hedge the currency risk into euro[11] (refer to Note 3.3.2), while the interest rate risk is addressed by interest rate swaps (refer Note 3.3.1).

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

2.5.1. Currency swaps and currency forward contracts

The ESM enters into currency swap and currency forward contracts in order to cover currency positions in its paid-in capital portfolio. 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'.

2.5.2. Cross currency swaps and interest rate swaps

The ESM enters into cross currency interest rate swap contracts in order to cover floating or fixed rates in different currencies in its paid-in capital portfolio as well as raised funds. In a cross-currency interest rate 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. Notional amounts are exchanged on the effective date and the maturity date. Ongoing forward and spot exchange transactions are converted at the spot rates of exchange prevailing on the balance sheet date and neutralised in 'Accruals and deferred income' or 'Prepayments and accrued income'.

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

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

The interest rate swaps represent contracts under which floating-rate interest shall be 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.

All interest rate swaps and cross currency interest rate swaps are concluded in 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.

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

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

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

2.7. Debt securities including fixed-income securities

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

2.7.1. Paid-in capital and reserve fund investments

The ESM's capital provisions are laid down in Chapter 3 of the ESM Treaty. The initial aggregate nominal value of paid-in shares was €80 billion and has been increased to €80.5 billion due to the accession of Latvia and Lithuania. The net income generated by ESM operations and the proceeds of the financial sanctions received from the ESM Members under the multilateral surveillance procedure, the excessive deficit procedure, and the macro-economic imbalances procedure established under the Treaty on the Functioning of the European Union (TFEU) are put aside in a reserve fund, in accordance with Chapter 5 of the ESM Treaty.

The paid-in capital and the reserve fund are invested in accordance with the ESM Investment Guidelines approved by the Board of Directors. The main objective of such investments is to ensure that the maximum lending volume is always readily available, and to absorb potential losses.

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

According to the 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 only.

The paid-in capital and the reserve fund investments are managed in different portfolios. As the Investment Guidelines specify, the paid-in capital is divided in Short-term tranche and the Medium- and long-term tranche, while the assets of the reserve fund are invested in full in the short-term tranche:

Short-term tranche

The tranche with the highest liquidity requirements is the short-term tranche. The main objective of the short-term tranche is to enable the ESM to face any temporary disbursement to cover any 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, with a high level of confidence.

Medium- and long-term tranche

The main objective of the medium- and long-term tranche is to ensure the ESM's financial strength. This tranche is managed to enhance the return of the paid-in capital and is subject to the constraints specified in the Investment Guidelines. This tranche is also mainly invested in liquid instruments.

The paid-in capital and the reserve fund investments 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.

2.7.2. Liquidity buffer investments

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

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

2.7.3. Determination of fair value

For financial instruments traded in active markets, the determination of fair values for financial assets and financial liabilities is based on quoted market prices or dealer price quotations.

A financial instrument is considered to be trading in an active market if quoted prices are readily and 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 active markets, they are determined using valuation techniques that include the use of mathematical models. The chosen valuation techniques incorporate factors that market participants would take into account in pricing a transaction and are based whenever possible on observable market data. If such data is not available, a degree of judgement is required in establishing fair values.

2.8. Loans and advances to credit institutions and to euro area Member States

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

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

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

2.9. Intangible assets

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

2.10. Tangible assets

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

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

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

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

2.11. Prepayments and accrued income

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

2.12. Amounts owed to credit institutions

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

2.13. Debts evidenced by certificates

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

2.14. Provisions

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

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

2.15. Subscribed capital

On 31 December 2017, the ESM's shareholders were the 19 euro area Member States. In accordance with Article 8 of the ESM Treaty, the authorised capital is €704.8 billion, which is divided into 7,047,987 shares, with a nominal value of €100,000 each. The authorised capital was subscribed by the shareholders according to the contribution key provided in Article 11 and calculated in Annex I of the ESM Treaty. The authorised capital is divided into paid-in shares and callable shares, where the total aggregate nominal value of paid-in shares is €80.5 billion.

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

2.16. Accruals and deferred income

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

2.17. Interest receivable and payable

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

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

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

2.18. Employee benefits

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

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

2.19. 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 Principles for Risk Management, the targeted risk appetite should preserve the ESM's funding capacity, ensure the highest creditworthiness, and avoid unexpected capital calls. The Risk Policy describes the risk appetite and the framework for identifying, assessing, monitoring and managing risks consistent with the risk appetite. It covers all ESM financial and non-financial risks, and both on- and, if applicable, off-balance sheet items. The risk profile is defined by a set of limits to curtail all types of risks within the risk appetite. The ESM does not aim at generating profit on financial support granted to beneficiary Member States and does not provide incentives for speculative exposures of its investment portfolio.

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 the Risk & Compliance Department. The Risk & Compliance Department 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 Risk Policy.

The Chief Risk Officer is the head of the Risk & Compliance Department and 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 Risk Policy approved by the Board of Directors. The IRC assists the Board of Directors 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.

3.2. Credit risk

Credit risk is defined as the potential for loss arising from the inability of a counterparty, issuer, insurer or other obligor to fulfil its contractual obligations for full value when due. Counterparty risk is considered a particular form of credit risk and derives from lending and support operations to beneficiary Member States, investment of paid-in capital, placement of possible excess liquidity, and hedging operations. Issuer risk is also a particular form of credit risk and derives from investment in securities of the paid-in capital 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 FFA, the credit risk in the ESM's lending exposure is accepted. Note 3.2.5 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 exposure to credit risk for the components of the balance sheet without taking into account any collateral or other credit enhancements. For on-balance-sheet positions, these exposures are based on net carrying amounts as reported on the balance sheet.

(in €'000)	Exposure 31.12.2017	Exposure 31.12.2016
Cash in hand, balances with central banks and post office banks	74,288,120	64,922,796
Loans and advances to credit institutions	369,174	1,514
Debt securities including fixed-income securities	20,890,684	30,463,047
On balance sheet credit risk exposure	**95,547,978**	**95,387,357**
Exposure at default on derivatives[1]	1,162,930	920,410
Credit risk exposure	**96,710,908**	**96,307,767**

[1] The cash-collateral is included in the calculation of the Exposure at Default and reported as exposure in the On balance sheet items. For comparison purpose, 2016 figure has been restated.

This table does not include 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.

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 issuers rating is presented. For other financial assets, the credit ratings of the counterparties are presented.

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

(in €'000)	Credit rating[1]	Clean carrying value 31.12.2017
Cash in hand, balances with central banks and post office banks	not rated[2]	74,285,731
	AA	2,389
Loans and advances to credit institutions	AA	101,514
	AA-	62,120
	A+	55,600
	A	149,940
Debt securities including fixed-income securities	AAA	12,129,744
	AA+	1,246,238
	AA	1,566,053
	AA-	1,244,951
	A+	177,703
	A	4,525,995
Total		**95,547,978**

[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.

(in €'000)	Credit rating[1]	Clean carrying value 31.12.2016
Cash in hand, balances with central banks and post office banks	not rated[2]	64,919,468
	AA	3,328
Loans and advances to credit institutions	AA	1,514
Debt securities including fixed-income securities	AAA	17,900,010
	AA+	2,858,372
	AA	6,558,157
	AA-	763,098
	A+	11,306
	A	2,372,104
Total		**95,387,357**

[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 and with the Bank for International Settlements, which do not have ratings.

3.2.3. Credit risk on debt securities including fixed-income securities

The ESM invests in assets that fulfil the high credit risk standards the Investment Guidelines require. 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 limit compliance daily.

3.2.4. Credit risk on derivatives

The credit risk for derivatives lies in the loss which the ESM would incur if a counterparty were unable to honour its contractual obligations.

With regard to derivative transactions, the ESM has contracted foreign exchange and interest rate derivative transactions in 2017. Operations contracted with commercial banks are fully collateralised, thanks to the exchange of cash and highly rated securities.

3.2.5. 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 is providing 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 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.

Structural interest rate risk is defined as the risk of a mismatch between the interest rate re-pricing of loans granted to beneficiary Member States and 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.

On 20 January 2017, the ESM Board of Directors approved three schemes aimed at reducing interest rate risk for Greece. As part of the short-term debt relief measures for Greece, the ESM received the mandate to reduce the country's interest rate risk. It allowed ESM to enter into Interest rate swaps arrangements that aimed to stabilise the ESM's overall cost of funding and reduce the risk that Greece would have to pay a higher interest rate on its loans when market rates start rising. The Interest Rate Swaps traded by the ESM are disclosed in Note 26.

All funding costs arising from refinancing risk are passed through to beneficiary Member States under financial assistance, as defined by the ESM Pricing Policy.

Non-structural interest rate risk is the risk of loss due to an adverse change in the overall level of interest rates affecting the value of the investment portfolio. Non-structural interest rate risk is monitored and controlled on a daily basis through risk indicators and stress tests. Duration bands, cumulated and partial sensitivities, 1 day Value at Risk 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 and limits frame the Short Term and the Medium to Long Term tranches 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 to Long Term Tranche.

Capital preservation is defined as the preservation of the Paid-in-Capital currently at €80.4 billion. The market value of the STT and MLTT investment portfolios shall not fall below this value over a relevant investment horizon, for a high level of confidence. The relevant investment horizon is set in relation to the nature of each portfolio:

- For the Short Term Tranche, the capital shall be preserved at a one-year horizon, for a high level of confidence.
- For the Medium to Long Term Tranche, the capital shall be preserved at a three-year horizon for a high level of confidence.

To assess capital preservation with a 'high level of confidence', a vast array of scenarios of interest rate movements are used to forecast the market value of the STT and the MLTT 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 impact to a given change in interest rates.

These scenarios, developed I 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 IMC.

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 – CSA - standards).

The Interest Rate Risk on the ESM investment portfolio is managed prudently to support the ESM's financial stability mandate, which requires the ESM to maintain financial soundness including in period of market stress.

3.3.2.Currency risk

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

The ESM is exposed to currency risk whenever there is a currency mismatch between its assets and liabilities. In 2017, the potential source of currency risk was the non-euro investments made in the investment portfolios and funding activities.

In 2017, the ESM had investment activities in foreign currency assets, mainly Swedish krona, Japanese yen and US dollars. On 31 December 2017, the nominal outstanding amount of currency swaps that hedge the foreign currency cash flow in the investment portfolio was €4.9 billion. The portfolio of bonds hedged by these currency swaps has an average duration of 3.4 years with a maturity of up to 8.2 years.

The ESM had also new 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 24 October 2017, the ESM priced its inaugural US dollar issue, raising $3 billion. The ESM does not run currency risk through the transaction, as it has hedged the proceeds back into euros.

According to the ESM Investment Guidelines, the ESM enters into derivative contracts for risk management purposes only.

As it is the case for Interest Rate Swaps, 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 – CSA - standards).

31 December 2017 (in €'000)	Euro (EUR)	Japanese Yen (JPY)	US Dollar (USD)	Swedish Krone (SEK)	Total
ASSETS					
Cash in hand, balances with central banks and post office banks	74,288,120	-	-	-	**74,288,120**
Loans and advances to credit institutions	369,174	-	-	-	**369,174**
Loans and advances to euro area Member States	76,194,688	-	-	-	**76,194,688**
Debt securities including fixed-income securities	15,981,269	4,536,847	181,947	190,621	**20,890,684**
Prepayments and accrued income	801,314	7,921	10,562	1,036	**820,833**
Total financial assets	**167,634,565**	**4,544,768**	**192,509**	**191,657**	**172,563,499**
LIABILITIES					
Amounts owed to credit institutions	32,600	-	-	-	**32,600**
Debt securities in issue	86,711,327	-	2,489,756	-	**89,201,083**
Other liabilities	8,488	-	-	-	**8,488**
Accruals and deferred income	677,335	82,069	25,180	4,992	**789,576**
Total financial liabilities	**87,429,750**	**82,069**	**2,514,936**	**4,992**	**90,031,747**
Shareholders' equity(1)	82,536,452	-	-	-	82,536,452
Total shareholders' equity(2)	**82,536,452**	-	-	-	**82,536,452**
Off-balance sheet derivatives	**2,639,552**	**(4,454,205)**	**2,317,018**	**(187,936)**	**314,429**
Net of financial position	**307,915**	**8,494**	**(5,409)**	**(1,271)**	**309,729**

31 December 2016 (in €'000)	Euro (EUR)	Japanese Yen (JPY)	US Dollar (USD)	Swedish Krone (SEK)	Total
ASSETS					
Cash in hand, balances with central banks and post office banks	64,922,796	-	-	-	64,922,796
Loans and advances to credit institutions	1,514	-	-	-	1,514
Loans and advances to euro area Member States	72,732,950	-	-	-	72,732,950
Debt securities including fixed-income securities	28,090,943	2,372,104	-	-	30,463,047
Prepayments and accrued income	449,161	2,322	-	-	451,483
Total financial assets	166,197,364	2,374,426	-	-	168,571,790
LIABILITIES					
Debt securities in issue	85,658,968	-	-	-	85,658,968
Other liabilities	12,068	-	-	-	12,068
Accruals and deferred income	462,598	133	-	-	462,731
Total financial liabilities	86,133,634	133	-	-	86,133,767
Shareholders' equity(1)	82,442,259	-	-	-	82,442,259
Total shareholders' equity(2)	82,442,259	-	-	-	82,442,259
Off-balance sheet derivatives	2,527,164	(2,367,339)	-	-	159,825
Net of financial position	148,635	6,954	-	-	155,589

(1) Excluding subscribed capital unpaid and subscribed capital called but not paid
(2) Shareholder equity has no defined maturity.

3.4. Liquidity risk

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

Funding liquidity risk is defined as the risk of loss arising from difficulty in securing the necessary funding, or from a significantly higher cost of funding than normal levels, due to a deterioration of the ESM's creditworthiness, or at a time of unfavourable market conditions (such as periods of high stress). Funding liquidity risk is managed by maintaining a permanent market access to a wide investor base, multiple credit lines and investing capital in high-credit-quality liquid assets that can be used to raise cash to meet obligations as they fall due. 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 2017, the ESM's liquidity buffer stood at €13.1 billion (2016: €13 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 proportion of a security issuance and adopting adequate measurements that allow the timely detection of liquidity deteriorations.

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

31 December 2017 (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	74,288,120	-	-	-	**74,288,120**
Loans and advances to credit institutions	369,174	-	-	-	**369,174**
Loans and advances to euro area Member States	-	-	-	76,194,688	**76,194,688**
Debt securities including fixed-income securities	64,902	1,542,344	16,039,694	3,243,744	**20,890,684**
Prepayments and accrued income	77,758	592,843	42,048	108,184	**820,833**
Total financial assets	**74,799,954**	**2,135,187**	**16,081,742**	**79,546,616**	**172,563,499**
LIABILITIES					
Amounts owed to credit institutions	32,600	-	-	-	**32,600**
Debt securities in issue	8,982,989	15,917,806	26,510,038	37,790,250	**89,201,083**
Other liabilities	8,488	-	-	-	**8,488**
Accruals and deferred income	256,026	319,934	149,157	64,459	**789,576**
Total financial liabilities	**9,280,103**	**16,237,740**	**26,659,195**	**37,854,709**	**90,031,747**
Shareholders' equity[1]	-	-	-	82,536,452	**82,536,452**
Total shareholders' equity[2]	**-**	**-**	**-**	**82,536,452**	**82,536,452**
Net of financial position	**65,519,851**	**(14,102,553)**	**(10,577,453)**	**(40,844,545)**	**(4,700)**

31 December 2016 (in €'000)	Less than 3 months	From 3 months to 1 year	From 1 to 5 years	More than 5 years	Total
ASSETS					
Cash in hand, balances with central banks and post office banks	64,922,796	-	-	-	**64,922,796**
Loans and advances to credit institutions	1,514	-	-	-	**1,514**
Loans and advances to euro area Member States	-	-	-	72,732,950	**72,732,950**
Debt securities including fixed-income securities	2,101,512	3,715,218	11,609,885	13,036,432	**30,463,047**
Prepayments and accrued income	222,673	228,810	-	-	**451,483**
Total financial assets	**67,248,495**	**3,944,028**	**11,609,885**	**85,769,382**	**168,571,790**
LIABILITIES					
Debt securities in issue	10,581,157	7,531,971	31,138,151	36,407,689	**85,658,968**
Other liabilities	12,068	-	-	-	**12,068**
Accruals and deferred income	121,924	155,842	161,667	23,298	**462,731**
Total financial liabilities	**10,715,149**	**7,687,813**	**31,299,818**	**36,430,987**	**86,133,767**
Shareholders' equity[1]	-	-	-	82,442,259	**82,442,259**
Total shareholders' equity[2]	**-**	**-**	**-**	**82,442,259**	**82,442,259**
Net of financial position	**56,533,346**	**(3,743,785)**	**(19,689,933)**	**(33,103,864)**	**(4,236)**

[1] Excluding subscribed capital unpaid and subscribed capital called but not paid
[2] The shareholder's equity has no defined maturity

3.5. Operational risk

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

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

Management has no tolerance for material operational risks, including those originating from third party/vendor engagements, which may result in the ESM's inability to effectively fulfil its mandate, or in significant loss and/or reputational damage. No material operational risk losses were identified in 2017.

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 the Risk & Compliance Department 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).The Risk & Compliance Department monitors these risks and reports on them to the Internal Risk Committee and to the Board Risk Committee.

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)	31.12.2017	31.12.2016
Current account balances with euro area central banks	74,285,731	64,919,468
Current account balances with other banks(1)	2,389	3,328
Total cash in hand, balances with central banks and post office banks	**74,288,120**	**64,922,796**

(1) 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.

5. Loans and advances to credit institutions

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

(in €'000)	31.12.2017	31.12.2016
Money market deposits with other banks	100,000	-
Cash collateral provided	267,660	-
Other deposits	1,514	1,514
Total loans and advances to credit institutions	**369,174**	**1,514**

Other deposits consist entirely of the lease guarantee deposit in relation to the ESM rental agreement. The cash collateral provided relates entirely to cross currency swaps and interest rate swaps transactions

6. Loans and advances to euro area Member States

In accordance with Article 9 of the ESM Treaty, the Board of Governors may decide to grant financial assistance in the form of a loan to an ESM Member (refer to Note 27).

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 2017
Loans to euro area Member States			
- to Spain	5	31,721,460	31,721,460
- to Cyprus	9	6,300,000	6,300,000
- to Greece	8	38,173,228	38,173,228
Total	22	76,194,688	76,194,688

	No. of loans	Nominal amount	Clean carrying value as at 31 December 2016
Loans to euro area Member States			
- to Spain	5	34,721,460	34,721,460
- to Cyprus	9	6,300,000	6,300,000
- to Greece	7	31,702,428	31,711,490
Total	21	72,723,888	72,732,950

The following table shows the movements of the loans to euro area Member States during 2016 and 2017:

(in €'000)	
1 January 2016 balance	63,445,582
New disbursements	10,300,000
- to Greece	*10,300,000*
Early repayments	(1,000,000)
- from Spain	*(1,000,000)*
Premiums/discounts amortisation	(12,632)
31 December 2016 balance	72,732,950

(in €'000)	
1 January 2017 balance	72,732,950
New disbursements	8,500,000
- to Greece	*8,500,000*
Early repayments	(5,029,200)
- from Spain	*(3,000,000)*
- from Greece	*(2,029,200)*
Premiums/discounts amortisation	(9,062)
31 December 2017 balance	76,194,688

7. Debt securities including fixed-income securities

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

(in €'000)	Clean amortised cost	Unrealised gains	Clean fair (carrying) value	Nominal amount
31.12.2017	20,791,565	99,119	20,890,684	20,402,049
31.12.2016	30,279,853	183,194	30,463,047	29,387,122

On 31 December 2017, the clean amortised cost of the debt securities was €20.8 billion (31 December 2016: €30.3 billion), against a clean fair value of €20.9 billion (31 December 2016: €30.5 billion). The difference represents the unrealised result and is recognised directly in the equity within the fair value reserve.

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 Risk & Compliance Department defines a limit structure to mitigate the maximum exposure per issuer.

All securities are 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 cover central banks, central governments, regional governments, local governments, supranational institutions and governmental agencies. On 31 December 2017, debt securities issued by public bodies amounted to €11.0 billion (31 December 2016: €21.0 billion), while debt securities issued by other borrowers amounted to €9.9 billion (31 December 2016: €9.5 billion).

Starting from 2015, the ESM has invested part of the paid-in capital portfolio in assets denominated in a foreign currency (refer to Note 3.3.2).

8. Intangible assets

The following table shows the movements of intangible assets during 2017:

(in €'000)	Software	Total intangible assets
Historical cost		
1 January 2017 balance	158	158
Additions	10	10
31 December 2017 balance	**168**	**168**
Accumulated amortisation		
1 January 2017 balance	(111)	(111)
Amortisation	(21)	(21)
31 December 2017 balance	**(132)**	**(132)**
Net book value		
31 December 2017 balance	**36**	**36**
31 December 2016 balance	**47**	**47**

9. Tangible assets

The following table shows the movements of tangible assets during 2017:

(in €'000)	Fixtures and fittings	Furniture and office equipment	Total tangible assets
Historical cost			
1 January 2017 balance	5,372	1,731	7,103
Additions	1,256	298	1,554
Disposals	-	(69)	(69)
31 December 2017 balance	**6,628**	**1,960**	**8,588**
Accumulated depreciation			
1 January 2017 balance	(1,564)	(1,350)	(2,914)
Depreciation	(748)	(285)	(1,033)
Of the disposed assets	-	23	23
31 December 2017 balance	**(2,312)**	**(1,612)**	**(3,924)**
Net book value			
31 December 2017 balance	**4,316**	**348**	**4,664**
31 December 2016 balance	**3,808**	**381**	**4,189**

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)	31.12.2017	31.12.2016
Interest receivable on:		
- Debt securities including fixed-income securities	78,988	121,917
- Loans and advances to euro area Member States	283,441	145,291
- Loans and advances to credit institutions	8	-
Amounts charged to the EFSF for administrative services (Note 21/28)	10,025	8,385
Commitment fee receivable	10,845	-
Prepayments	845	1,238
Amounts from sanctions to Member States[1]	18,930	-
Other[2]	417,751	174,652
Total prepayments and accrued income	**820,833**	**451,483**

(1) The ESM expects to receive the payments of certain sanctions paid by its Member States (refer to Note 24).
(2) "Other" represents the spot revaluation, spread amortisation and accrued income of ongoing derivative transactions (refer to Note 2.11).

11. Amounts owed to credit institutions

On 31 December 2017, the €32.6 million of amounts owed to credit institutions were composed entirely of cash collateral received for the cross currency swaps and interest rate swaps (31 December 2016: €nil million).

12. Debts evidenced by certificates

The following table discloses the details of debt securities in issue outstanding on 31 December 2017, 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	EU000A1U98Z1	7,000,000	15/10/2013	15/10/2018	1.250%
Long-term Funding	EU000A1U9811	6,000,000	04/03/2014	04/03/2021	1.375%
Long-term Funding	EU000A1U9829	3,000,000	14/05/2014	15/10/2019	0.875%
Long-term Funding	EU000A1U9829(2)	2,000,000	28/07/2015	15/10/2019	0.875%
Long-term Funding	EU000A1U9886	6,000,000	15/09/2015	17/12/2018	0.050%
Long-term Funding	EU000A1U9894	3,000,000	23/09/2015	23/09/2025	1.000%
Long-term Funding	EU000A1U9894(2)	999,850	29/09/2016	23/09/2025	1.000%
Long-term Funding	EU000A1U9902	3,000,000	20/10/2015	20/10/2045	1.750%
Long-term Funding	EU000A1U9910	4,000,000	03/11/2015	03/11/2020	0.100%
Long-term Funding	EU000A1U9910(2)	992,750	11/03/2016	03/11/2020	0.100%
Long-term Funding	EU000A1U9928	1,500,000	17/11/2015	17/11/2036	1.625%
Long-term Funding	EU000A1U9928(2)	1,000,000	31/03/2016	17/11/2036	1.625%
Long-term Funding	EU000A1U9936	1,000,000	01/12/2015	01/12/2055	1.850%
Long-term Funding	EU000A1U9936(2)	1,000,000	01/03/2016	01/12/2055	1.850%
Long-term Funding	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	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	EU000A1U9985	3,000,000	18/10/2016	18/10/2022	0.000%
Long-term Funding	EU000A1U9985(2)	996,500	16/11/2017	18/10/2022	0.000%
Long-term Funding	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%

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Type of funding/ Programmes	ISIN code	Nominal amount (in €'000)	Issue date	Maturity date	Coupon
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	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	XS1704649158[(4)]	2,501,459	31/10/2017	03/11/2022	2.125%
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	EU000A1Z9790[(1)]	1,500,000	20/07/2017	25/01/2018	N/A
Short-term Funding	EU000A1Z98B1[(1)]	1,484,400	24/08/2017	22/02/2018	N/A
Short-term Funding	EU000A1Z98D7[(1)]	1,499,850	21/09/2017	22/03/2018	N/A
Short-term Funding	EU000A1Z98E5[(1)]	1,496,600	05/10/2017	11/01/2018	N/A
Short-term Funding	EU000A1Z98F2[(1)]	1,423,600	19/10/2017	19/04/2018	N/A
Short-term Funding	EU000A1Z98G0[(1)]	1,496,700	09/11/2017	08/02/2018	N/A
Short-term Funding	EU000A1Z98H8[(1)]	1,493,450	23/11/2017	24/05/2018	N/A
Short-term Funding	EU000A1Z98J4[(1)]	1,497,800	07/12/2017	08/03/2018	N/A
Total		**88,929,659**			

(1) Zero-coupon bond
(2) Tap issue
(3) N-bond with technical ISIN: the ESM issued its first N-bond (Namensschuldverschreibungen) in 2016. N-Bonds are privately placed, long-term funding instruments that are neither centrally cleared nor listed.
(4) USD denominated debt securities issued starting with 2017.

The following table discloses the details of debt securities in issue outstanding on 31 December 2016, together with the coupon rates and due dates.

Type of funding/ Programmes	ISIN code	Nominal amount (in €'000)	Issue date	Maturity date	Coupon
Greece	EU000A1U9852[3]	813,154	01/12/2015	27/02/2017	6M Euribor - 18 bps
Greece	EU000A1U9860[3]	811,860	01/12/2015	27/08/2017	6M Euribor - 20 bps
Greece	EU000A1U9878[3]	1,081,081	01/12/2015	27/02/2018	6M Euribor - 21 bps
Greece	EU000A1U9852[3]	809,755	08/12/2015	27/02/2017	6M Euribor - 18 bps
Greece	EU000A1U9860[3]	808,948	08/12/2015	27/08/2017	6M Euribor - 20 bps
Greece	EU000A1U9878[3]	1,077,630	08/12/2015	27/02/2018	6M Euribor - 21 bps
Long-term Funding	EU000A1U98Z1	7,000,000	15/10/2013	15/10/2018	1.250%
Long-term Funding	EU000A1U9803	3,000,000	20/11/2013	20/11/2023	2.125%
Long-term Funding	EU000A1U9811	6,000,000	04/03/2014	04/03/2021	1.375%
Long-term Funding	EU000A1U9829	3,000,000	14/05/2014	15/10/2019	0.875%
Long-term Funding	EU000A1U9803[2]	990,750	27/06/2014	20/11/2023	2.125%
Long-term Funding	EU000A1U9845	3,000,000	17/03/2015	17/10/2017	0.000%
Long-term Funding	EU000A1U9829[2]	2,000,000	28/07/2015	15/10/2019	0.875%
Long-term Funding	EU000A1U9886	6,000,000	15/09/2015	17/12/2018	0.050%
Long-term Funding	EU000A1U9894	3,000,000	23/09/2015	23/09/2025	1.000%
Long-term Funding	EU000A1U9902	3,000,000	20/10/2015	20/10/2045	1.750%
Long-term Funding	EU000A1U9910	4,000,000	03/11/2015	03/11/2020	0.100%
Long-term Funding	EU000A1U9928	1,500,000	17/11/2015	17/11/2036	1.625%
Long-term Funding	EU000A1U9936	1,000,000	01/12/2015	01/12/2055	1.850%
Long-term Funding	ESMNBOND0001[4]	80,000	22/01/2016	22/01/2041	1.572%
Long-term Funding	ESMNBOND0002[4]	30,000	10/02/2016	10/02/2041	1.360%
Long-term Funding	EU000A1U9936[2]	1,000,000	01/03/2016	01/12/2055	1.850%
Long-term Funding	EU000A1U9944[2]	3,000,000	02/03/2016	02/03/2026	0.500%
Long-term Funding	ESMNBOND0003[4]	25,000	09/03/2016	09/03/2056	1.559%
Long-term Funding	ESMNBOND0004[4]	25,000	09/03/2016	09/03/2056	1.559%
Long-term Funding	EU000A1U9910[2]	992,750	11/03/2016	03/11/2020	0.100%
Long-term Funding	EU000A1U9928[2]	1,000,000	22/03/2016	17/11/2036	1.625%
Long-term Funding	ESMNBOND0005[4]	25,000	31/03/2016	22/03/2046	1.316%
Long-term Funding	ESMNBOND0006[4]	30,000	11/04/2016	11/04/2046	1.220%
Long-term Funding	EU000A1U9951	3,000,000	22/04/2016	22/04/2024	0.125%
Long-term Funding	EU000A1U9969	3,000,000	03/05/2016	03/05/2032	1.125%
Long-term Funding	EU000A1U9944	2,500,000	19/07/2016	02/03/2026	0.500%
Long-term Funding	EU000A1U9977	2,500,000	19/07/2016	18/07/2042	0.875%
Long-term Funding	EU000A1U9951[2]	961,100	28/07/2016	22/04/2024	0.125%
Long-term Funding	ESMNBOND0007[4]	40,000	03/08/2016	03/08/2056	1.156%
Long-term Funding	ESMNBOND0008[4]	150,000	09/08/2016	09/08/2056	1.150%
Long-term Funding	ESMNBOND0009[4]	50,000	19/08/2016	19/08/2053	1.025%
Long-term Funding	ESMNBOND0010[4]	50,000	19/08/2016	18/08/2056	1.064%
Long-term Funding	ESMNBOND0011[4]	50,000	19/09/2016	19/09/2051	1.030%
Long-term Funding	EU000A1U9894[2]	999,850	29/09/2016	23/09/2025	1.000%

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Type of funding/ Programmes	ISIN code	Nominal amount (in €'000)	Issue date	Maturity date	Coupon
Long-term Funding	EU000A1U9969[2]	1,000,000	18/10/2016	03/05/2032	1.125%
Long-term Funding	EU000A1U9985	3,000,000	18/10/2016	18/10/2022	N/A*
Long-term Funding	ESMNBOND0012[4]	50,000	19/10/2016	19/10/2054	1.145%
Long-term Funding	ESMNBOND0013[4]	40,000	19/10/2016	19/10/2056	1.125%
Long-term Funding	ESMNBOND0014[4]	25,000	27/10/2016	27/10/2056	1.086%
Long-term Funding	EU000A1U9951[2]	989,750	11/11/2016	22/04/2024	0.125%
Short-term Funding	EU000A1Z97L2[1]	1,498,250	21/07/2016	26/01/2017	N/A
Short-term Funding	EU000A1Z97N8[1]	1,492,700	18/08/2016	23/02/2017	N/A
Short-term Funding	EU000A1Z97Q1[1]	1,495,800	22/09/2016	23/03/2017	N/A
Short-term Funding	EU000A1Z97R9[1]	1,499,250	06/10/2016	12/01/2017	N/A
Short-term Funding	EU000A1Z97S7[1]	1,467,300	20/10/2016	20/04/2017	N/A
Short-term Funding	EU000A1Z97T5[1]	1,491,200	10/11/2016	09/02/2017	N/A
Short-term Funding	EU000A1Z97U3[1]	1,434,000	24/11/2016	18/05/2017	N/A
Short-term Funding	EU000A1Z97V1[1]	1,473,200	08/12/2016	09/03/2017	N/A
Total		**85,358,328**			

(1) Zero-coupon bond
(2) Tap issue
(3) Floating rate notes issued for disbursements in kind (cashless disbursements)
(4) N-bond with technical ISIN: the ESM issued its first N-bond (Namensschuldverschreibungen) in 2016. N-Bonds are privately placed, long-term funding instruments that are neither centrally cleared nor listed.

The following table shows the movements of the debt securities in issue in 2016 and 2017:

(in €'000)	
1 January 2016 balance	**72,054,845**
Issuance during the period	60,036,718
Maturities during the year	(46,359,700)
Premiums/discounts amortisation	(72,895)
31 December 2016 balance	**85,658,968**

(in €'000)	
1 January 2017 balance	**85,658,968**
Issuance during the period	51,736,229
Maturities during the year	(48,083,455)
Premiums/discounts amortisation	(110,659)
31 December 2017 balance	**89,201,083**

All debt securities in issue on 31 December 2016 and 31 December 2017 are issued under English law as the governing law, except the N-bonds which are issued under German law.

13. Other liabilities

On 31 December 2017, the other liabilities were composed of suppliers' invoices and staff cost related payables which were not yet settled, amounting to €8.5 million (31 December 2016: €12.1 million).

14. Accruals and deferred income

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

(in €'000)	31.12.2017	31.12.2016
Interest payable cash and cash equivalents	25,776	-
Interest payable on loans to credit institutions	244	-
Interest payable on debts evidenced by certificates	251,670	206,759
Deferred income on up-front service fee	224,203	241,075
Other[1]	287,683	14,897
Total accruals and deferred income	**789,576**	**462,731**

[1] "Other" represents the spot revaluation and spread amortisation of ongoing derivative transactions (refer to Note 2.16 and 2.5).

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

15. Subscribed capital

(in €'000)	Subscribed capital	Subscribed, uncalled capital	Subscribed, called capital
1 January 2016	704,798,700	(624,250,300)	80,548,400
Subscription to the authorised capital	-	-	-
Authorised capital calls	-	-	-
31 December 2016	704,798,700	(624,250,300)	80,548,400

(in €'000)	Subscribed capital	Subscribed, uncalled capital	Subscribed, called capital
1 January 2017	704,798,700	(624,250,300)	80,548,400
Subscription to the authorised capital	-	-	-
Authorised capital calls	-	-	-
31 December 2017	704,798,700	(624,250,300)	80,548,400

On 31 December 2017, 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 2017 Latvia had made the first four instalments for the payment of paid-in shares in the amount of €176.9 million. 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 2017 Lithuania had made the first three instalments for the payment of paid-in shares in the amount of €196.3 million.

On 31 December 2017, the authorised capital was €704.8 billion (31 December 2016: €704.8 billion), divided into 7,047,987 shares (31 December 2016: 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 2016: €624.3 billion) is callable. On 31 December 2017, the called subscribed capital amounted to €80.5 billion (31 December 2016: €80.5 billion), of which €80.4 billion (31 December 2016: €80.3 billion) is paid.

ESM Members 31 December 2017	ESM Key (%)	Number of shares	Subscribed capital (in €'000)	Subscribed capital called and paid (in €'000)
Kingdom of Belgium	3.4534	243,397	24,339,700	2,781,680
Federal Republic of Germany	26.9616	1,900,248	190,024,800	21,717,120
Republic of Estonia	0.1847	13,020	1,302,000	148,800
Ireland	1.5814	111,454	11,145,400	1,273,760
Hellenic Republic	2.7975	197,169	19,716,900	2,253,360
Kingdom of Spain	11.8227	833,259	83,325,900	9,522,960
French Republic	20.2471	1,427,013	142,701,300	16,308,720
Italian Republic	17.7917	1,253,959	125,395,900	14,330,960
Republic of Cyprus	0.1949	13,734	1,373,400	156,960
Republic of Latvia	0.2746	19,353	1,935,300	176,960
Republic of Lithuania	0.4063	28,634	2,863,400	196,320
Grand Duchy of Luxembourg	0.2487	17,528	1,752,800	200,320
Malta	0.0726	5,117	511,700	58,480
Kingdom of the Netherlands	5.6781	400,190	40,019,000	4,573,600
Republic of Austria	2.7644	194,838	19,483,800	2,226,720
Portuguese Republic	2.4921	175,644	17,564,400	2,007,360
Republic of Slovenia	0.4247	29,932	2,993,200	342,080
Slovak Republic	0.8184	57,680	5,768,000	659,200
Republic of Finland	1.7852	125,818	12,581,800	1,437,920
Total	**100.00**	**7,047,987**	**704,798,700**	**80,373,280**

On 31 December 2017, the subscribed capital called but not paid amounted to €0.2 billion and was related to Latvia and Lithuania (31 December 2016: €0.3 billion related to Latvia and Lithuania).

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

i. 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.

ii. A capital call under Article 9(2) of the ESM Treaty to replenish 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.

iii. 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 call 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 15 June 2017, the Board of Governors decided at their annual meeting to appropriate the net result of 2016 amounting to €568.8 million to the reserve fund. As a result the outstanding balance of the reserve fund as at 31 December 2017 is €2.0 billion (2016: €1.4 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)	2017	2016
Interest on loans[1]	877,608	644,201
Amortisation loan premium	(9,062)	(12,633)
Amortisation up-front service fee	59,373	52,629
Commitment fee	10,845	-
Total interest and similar income	**938,764**	**684,197**

[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)	2017	2016
Euro area issuers	22,734	28,683
Other EU issuers	8,359	10,817
EU supranational organisations	5,034	13,727
Total European Union	36,127	53,227
Other non-EU issuers	12,089	11,906
Other supranational organisations	3,606	8,358
Total outside the European Union	15,695	20,264
Total interest and similar income	51,822	73,491

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

On 31 December 2017, the interest payable and similar charges on cash and cash equivalents represents negative interest paid for the balances with central banks and amounts to €273.7 million (2016: € nil). The ESM is being charged a negative interest rate (- 0.40% per annum) on the cash held at national central banks starting from February 2017. In order to limit the negative implications on ESM's paid-in capital the concerned Member States expressed their willingness to compensate the ESM, under certain conditions, up to the amount charged by their national central banks (refer to Note 29).

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 from 1 January 2013. Under the 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 2017, the ESM charged the EFSF €30.9 million (2016: €26.7 million), from which €10.0 million had yet to be paid on the balance sheet date (refer to Note 10).

In 2017, the cumulated internal tax on salaries retained from staff members amounting to €5.0 million for the years 2013 to 2016 and €1.7 million for 2017 has been transferred to "Other operating income". 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)	2017	2016
Net realised result of sales of debt securities	27,032	287,073
Net foreign exchange result	142	-
Total net result on financial operations	27,174	287,073

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 are carried at fair value and unrealised gains and losses are recorded in the equity within the fair value reserve.

22. Staff costs

Staff costs are detailed as follows:

(in €'000)	2017	2016
Salaries(1) and allowances	22,841	20,213
Social security costs	1,251	1,034
Pension costs	7,074	6,084
Total staff costs	**31,166**	**27,331**

(1) Of which €1.6 million (2016: €1.6 million) relate to the ESM Management Board members, including €0.36 million (2016: €0.35 million) to the ESM Managing Director.

The ESM employed 174 persons on 31 December 2017 (164 on 31 December 2016).

In addition to its own employees, the ESM has expenses for employees seconded from other International Financial Institutions, as well as interim and temporary staff hired from external agencies. The related costs amount to €1.2 million for the 2017 financial year (2016: €0.8 million) and are accounted for as 'Other administrative expenses' (refer to Note 23).

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)	2017	2016
Outsourced services (mainly IT, HR and accounting services)	8,456	8,362
Treasury related services	1,298	880
Advisory services	4,815	4,492
Rental and related services	3,429	2,877
IT Hardware	2,742	2,581
Interim and secondment fees (Note 22)	1,219	817
Legal services	1,269	1,045
Rating agencies fees	385	488
Other services	5,406	4,204
Total other administrative expenses	**29,019**	**25,746**

24. Extraordinary income

The extraordinary income amounting to €18.93 million (2016: € nil million) is related to an amount that the ESM shall receive from the European Commission, following a final sentence of the Court of Justice in December 2017[12], which confirmed the Council implementing decision imposing a fine on a Member State.

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

The financial sanction imposed on Spain by Council implementing decision (EU) 2015/1289 on 13 July 2015 is a sanction pursuant to Article 8(1) Regulation (EU) No. 1173/2011. Such sanctions are collected by the European Commission and are assigned to the ESM.[13]

12 ECLI:EU:C:2017:982
13 Cf. Article 10 of Regulation 1173/2011.

25. Off-balance commitments

The off-balance sheet commitments represent the undisbursed part of the financial assistance programme to Greece and amounts to €45.8 billion (2016: €54.3 billion):

Any further disbursement is subject to conditionality in line with the Memorandum of Understanding attached to the Financial Assistance Facility Agreement.

26. Derivatives

The ESM uses derivatives for risk management purposes only, as described in Note 2.5. Since 2015, the ESM has been entering into foreign exchange derivative transactions such as currency swaps and currency forward contracts to hedge the currency risk related to non-euro denominated investments. Starting with 2017, the ESM has entered into interest rate swaps and cross currency swaps for the purpose of hedging interest rate risk on euro and non-euro denominated issued debt, as well as non-euro denominated investments.

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

The following table discloses the details of derivatives outstanding as at 31 December 2017, together with their fair value.

(in €'000)	Notional Amounts (receivable)	Notional Amounts (payable)	Fair Value
Interest rate swaps	36,512,000	(36,512,000)	(130,141)
Cross-currency interest rate swaps	5,788,261	(5,730,986)	(33,666)
Currency swaps	2,305,628	(2,048,620)	260,602
Currency forwards	1,363	(1,216)	148
Total	**44,607,252**	**(44,292,822)**	**96,943**

The following table discloses the details of derivatives outstanding as at 31 December 2016, together with their fair value.

(in €'000)	Notional Amounts (receivable)	Notional Amounts (payable)	Fair Value
Currency swaps[1]	2,943,375	(2,783,679)	159,696
Currency forwards	2,356	(2,227)	129
Total	**2,945,731**	**(2,785,906)**	**159,825**

[1] For comparison purpose, 2016 figures have been restated.

On 31 December 2017, the derivative financial instruments had a maximum maturity up to 30 years (2016: maximum maturity up to 2 years) and were concluded with euro area central banks, the Bank of International Settlements or commercial banks.

26.1 Interest receivable and interest payable on derivatives

The following table discloses the details of result on derivative contracts during the year ending on 31 December 2017.

(in €'000)	Interest receivable and similar income	Interest payable and similar charges	Net result
Interest result on Interest rate swaps	42,814	(141,797)	(98,983)
Interest result on cross-currency interest rate swaps	11,819	(11,114)	705
Fees on cross-currency interest rate swaps	10,137	(36)	10,101
Spread on currency swaps	5,881	(6,548)	(667)
Spread on currency forwards	688	(447)	241
Total	71,339	(159,942)	(88,603)

The following table discloses the details of result on derivatives contracts during the year ending on 31 December 2016.

(in €'000)	Interest receivable and similar income	Interest payable and similar charges	Net result
Spread on currency swaps	3,698	(2,782)	916
Spread on currency forwards	466	(440)	26
Total	4,164	(3,222)	942

The realised part included in 'Interest receivable and similar income' amounts to €25.1 million (2016: €3.2 million), while for 'Interest payable and similar charges' this represents €22.4 million (2016: €1.8 million).

27. 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.

Transactions with the European Financial Stability Facility (EFSF)

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

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

The EFSF has asked the ESM to provide administrative services and other support services to facilitate the performance of its activities. To formalise this cooperation, the two organisations have entered into a service level agreement. In line with the terms of this agreement, the ESM charged the EFSF €30.9 million for the financial year 2017 (2016: €26.7 million), from which €10.0 million had not yet been paid at balance sheet date (refer to Note 10). The ESM recognised these amounts as other operating income in the profit and loss account.

Transactions with the Chairperson of the ESM Board of Governors

In October 2017, the ESM appointed Jeroen Dijsselbloem as strategic advisor to the ESM Managing Director. Mr Dijsselbloem held this position as an external service provider until the end of his term as Eurogroup President on 13 January 2018. During this period, he remained Chairperson of the ESM Board of Governors. Mr Dijsselbloem was remunerated during this time in line with the ESM's standard contracts for external service providers until the end of his term on 13 January 2018.

28. Audit fee

In accordance with Article 22(2) of the ESM By-Laws which requires a mandatory rotation of the external auditors every six years, the ESM Board of Governors appointed on 15 June 2017 Ernst&Young, Société Anonyme as new auditor in replacement of PricewaterhouseCoopers, Société Cooperative.

The total fees accrued in 2017 by the ESM to Ernst&Young, Société Anonyme and the total fees accrued in 2016 by the ESM to PricewaterhouseCoopers, Société Cooperative are presented as follows:

(in €'000)	2017	2016
Audit fees	249	243
Audit related fees[1]	205	-
Total Audit fees	454	243

[1] In 2017, the external auditor and the former external auditor provided the ESM with audit related services in relation with the 2017 issuance of comfort letters for the ESM's first US-dollar denominated bond issuance.

29. Events after the reporting period

On 3 January 2018, the ESM received a transfer of €86.7 million from the French Republic, following the approval of the French Parliament. This transfer was made with view to a political commitment to return to the ESM the equivalent of the negative interest paid on deposits held at Banque de France in 2017 and in anticipation of a similar action to be taken by other ESM Members.

05 External auditor's report on the 2017 financial statements

To the Board of Governors of the European Stability Mechanism

Luxembourg, March 27, 2018

Opinion

We have audited the financial statements of European Stability Mechanism (the "Entity" or "ESM"), which comprise the balance sheet as at 31 December 2017, 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 2017, 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 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 Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants ("IESBA Code") as adopted for Luxembourg by the CSSF together with the ethical requirements that are relevant to our audit of the financial statements, and have fulfilled our other ethical responsibilities under those ethical requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key audit matters

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

Impairment of loans and advances

As at 31 December 2017, the loans and advances to euro area Member States amounted to EUR 76.2 billion and related to financial assistance granted to Spain, Cyprus and Greece in line with ESM's mission to provide financial assistance to euro area countries experiencing or threatened by severe financing problems. These loans were granted to recapitalise banks in Spain, and as part of a macroeconomic adjustment programme in the case of Cyprus and Greece. For the year ending 31 December 2017, no impairment has been recorded by ESM on these outstanding loans.

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

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

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

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

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

How the matter was addressed in our audit

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

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

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

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

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

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

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

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

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

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Entity's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the Board of Directors.
- Conclude on the appropriateness of Board of Directors' use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Entity's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our report of the "réviseur d'entreprises agréé" to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our report of the "réviseur d'entreprises agréé". However, future events or conditions may cause the Entity to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

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

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

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

We have been appointed as "réviseur d'entreprises agréé" by the Board of Governors on 15 June 2017 and the duration of our uninterrupted engagement, including previous renewals and reappointments, is 1 year.

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

EY

Bernard Lhoest
Luxembourg, March 27, 2018

06 Report of the Board of Auditors on the 2017 financial statements

Luxembourg, 27 March 2018

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.[14]

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 2017.

In 2015 the ESM completed the development of its internal control framework (ICF). This allowed the ESM Management to assert that during 2016, the first full year of operation of this framework, the ESM maintained effective internal controls. The oversight of the internal control framework is taken into account by the Board of Auditors in its work programme on an ongoing basis. The Board of Auditors notes that during 2017, the ESM Management maintained the established internal control framework. The Board of Auditors also notes that the ESM has itself identified several improvements to be made in 2018 and is supportive of their timely completion.

The Board of Auditors notes that, to the best of its judgment, no material matters have come to its attention that would prevent it from recommending that the Board of Governors approve the ESM financial statements for the year ended 31 December 2017.

On behalf of the Board of Auditors

Kevin Cardiff
Chairperson

[14] 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 2017 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
APP	Asset Purchase Programmes
BoD	Board of Directors
BoG	Board of Governors
Bps	Basis points
CoCos	Contingent Convertible bonds
ECB	European Central Bank
EFSF	European Financial Stability Facility
ESM	European Stability Mechanism
GDP	Gross domestic product
GLF	Greek Loan Facility
IFI	International financial institution
IMF	International Monetary Fund
NPL	Non-performing loan
NPV	Net present value
SSM	Single Supervisory Mechanism

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
JP	Japan
UK	United Kingdom
US	United States

European Stability Mechanism

EUROPEAN STABILITY MECHANISM

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