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Treaty establishing the European Stability Mechanism

2 FEBRUARY 2012

The ESM treaty was signed by euro area member states on 2 February 2012. The ESM will be an international financial institution based in Luxembourg. Its purpose will be to provide financial assistance to its members (euro area member states), experiencing or being threatened by severe financing problems, if indispensable for safeguarding financial stability in the euro area as a whole.

The original version of the treaty was signed on 11 July 2011, but it has been modified to incorporate decisions taken by the heads of state and government of the euro area on 21 July and 9 December 2011, aimed at improving the effectiveness of the mechanism.

The treaty will have to be ratified by the 17 euro area member states; it will enter into force and the ESM become operational as soon as possible: the target date is July 2012, a year earlier than originally planned. As a permanent mechanism, the ESM will take over the tasks currently fulfilled by the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM). With the accelerated entry into force, the ESM will now operate alongside the EFSF for 12 months. Their joint lending capacity is currently set at € 500 billion, subject to reassessment in March 2012.

With the subscribed capital of € 700 billion (€ 80 billion as paid in capital, the rest as callable), the initial maximum lending capacity of the ESM is set at € 500 billion.

Following are the main changes made by the updated treaty:

1) new financing tools
2) more flexible pricing
3) link with fiscal compact
4) new emergency decision-making procedure
5) alignment with IMF practice as regards private sector involvement
6) timing of capital contribution

1) The future ESM will be able to use a range of new instruments that have been put in place for the EFSF. Besides loans to beneficiaries, it will provide precautionary financial assistance (article 14) and loans to member states for recapitalisations of financial institutions (article 15). It will also be able to purchase bonds of beneficiary member states on primary and secondary markets (articles 17 and 18). This enlarged range of instruments is aimed at increased efficiency of the ESM.

The previous version of the treaty only provided for financial assistance in the form of a loan to an ESM member state, while the purchase of bonds on the primary market was only provided for "as an exception". The updated treaty eliminates the exceptional nature of primary market purchases and also provides for bond purchases on secondary markets, precautionary financial assistance "in the form of a precautionary conditioned credit line or in the form of an enhanced conditions credit line" and financial assistance through loans to an ESM member state for the specific purpose of recapitalising its financial institutions.

2) In order to help beneficiary member states ensure sustainability of their debt, the conditions for financial assistance have been eased in comparison to the original text. The new ESM treaty no longer includes an annex with pre-defined margins on its loans. Instead, the price should be equivalent to the lending rates of the EU's balance of payments facility (for non-euro member states), whilst covering financing and operating costs and including an appropriate margin (article 20). Maturities can extend up to 30 years.

3) Assistance will be provided under strict economic policy conditionality. Furthermore, the modified treaty establishes a new precondition for benefiting from such assistance as of 1 March 2013 (recital 5): member states concerned must ratify the so-called "fiscal compact", i.e. the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, and implement the balanced budget rule as specified in that treaty within the agreed timeline (one year after entry into force).

4) The most important decisions under the ESM will be taken by its board of governors (ministers with responsibility for finance) by mutual agreement. However, the modified Treaty provides for an emergency procedure whereby a decision to grant financial assistance can be taken by qualified majority of 85% of votes cast. This procedure can be used where the Commission and the European Central Bank both conclude that a failure to urgently adopt a decision to grant or implement financial assistance would threaten the economic and financial sustainability of the euro area.

When this procedure is used, "a transfer from the reserve fund and/or the paid-in capital to an emergency reserve fund is made in order to constitute a dedicated buffer to cover the risks arising from the financial support granted under this procedure" (article 4(4)).

5) The ESM will cooperate very closely with the International Monetary Fund (IMF) in providing stability support. The active participation of the IMF will be sought, both at technical and financial level. In accordance with IMF practice, in exceptional cases an adequate and proportionate form of private sector involvement will be considered in cases where stability support is provided, accompanied by conditionality in the form of a macro-economic adjustment programme. This provision has been moved from an operative article, in the initial treaty, to a recital in the update treaty (recital 12).

The treaty requires collective action clauses to be included, as of 1 January 2013, in all new euro area government securities with maturity above one year (recital 11 and article 12(3)).

6) ESM members are required in principle to ensure the required amount of paid-in capital gradually, within the first five years from the ESM's creation. The modified treaty however enables them to accelerate this process (article 41 (3)).

Text of the Treaty: http://www.european-council.europa.eu/media/582311/05-tesm2.en12.pdf