Possible use of ESM credit lines as part of the corona virus response

On 24 March, the Eurogroup broadly supported making available to ESM Members a Pandemic Crisis Support safeguard in accordance with the provisions of the ESM Treaty, building on the framework of the existing Enhanced Conditions Credit Line (ECCL). The purpose of this credit line would be to support ESM Members' financing needs related to their immediate healthcare and economic responses. The instrument would aim to protect Members' ability to quickly resume economic activity and to maintain access to capital markets, thereby safeguarding their financial stability and that of the euro area. It would be used only where indispensable for achieving this purpose. With these features, it would complement financial support and other initiatives at the euro area and EU level. This proposal could be combined with a new Rapid Financing Instrument (RFI), presented in Annex 3 to this note.

<u>Operational modalities of the pandemic response ECCL</u>

Instrument: ESM precautionary credit lines are designed to provide insurance against tail-risk events for countries with a sound general economic and financial situation. Currently, this tail risk is materialising in the form of a symmetric pandemic shock. Therefore, the purpose of this instrument would be to provide support to all ESM Members responding to the corona virus outbreak. Precautionary support would be available in the form of an ECCL on the basis of the highly unpredictable economic effect of the corona outbreak. The line could be disbursed, if necessary, via a loan or primary market purchases.

Volume/Access: Significant resources should be allocated to Pandemic Crisis Support, around 2% of an ESM Member's GDP as a benchmark, which could be adjusted depending on the development of the pandemic.

Eligibility: ESM support in the form of an ECCL would be made available to all ESM Members whose general economic and financial situation remains sound.

Conditions: ESM support would be subject to standardised terms and conditional on the beneficiary Member committing to applying its economic policy toward decisively addressing the corona outbreak as rapidly as possible. If the credit line is drawn, ESM support should be used specifically for health and incurred economic costs of responding to the corona outbreak. The Member would also commit to respecting the EU fiscal rules and European Semester. This includes any flexibility applied to these surveillance frameworks by the competent EU institutions in response to the exogenous shock. These conditions would be specified in a Memorandum of Understanding (MoU, see also Annex 1).

Process: The Eurogroup [or Euro Summit] would announce the availability of the pandemic response ECCL for all ESM Members. The process to grant stability support, as foreseen in the ESM Treaty, would follow this announcement (see also Annex 2). Such process of coordinated communication would send a strong and credible signal to markets and mitigate any stigma effect.

IMF involvement: Under the ESM Treaty, the ESM Member requesting support is "expected, whenever possible, to address a similar request to the IMF"[1]. This is an expectation rather than a rigid requirement on the Member. Conversely, it is required that "The active participation of the IMF will be sought, both at technical and financial level"[2]. In the current circumstances, the consultation with the IMF could be done by the ESM together with the European Commission rather than by the

[1] Preamble 8 ESM Treaty
[2] Preamble 8 ESM Treaty

requesting Member. IMF involvement is also specified as part of the conditionality and monitoring, "where appropriate and possible". The IMF has made available its rapid financing facilities in response to the corona crisis to low income and emerging market countries. Almost 80 countries are requesting IMF help in the context of corona virus. Accordingly, IMF involvement is only feasible in a technical advisory capacity.

Availability period and maturities: In line with the existing guideline, the ESM could disburse under the credit line over the initial availability period of twelve months, which could be extended to up to two years. Disbursements would need to be repaid over the medium term [within an average maturity of 5-10 years].

Disbursements: Once granted, the ESM could disburse at any time during the availability period, each time up to the agreed amount for a single disbursement, which will be set in the initial decision to grant a credit line. Each Member would inform the ESM of its intention to draw funds, as foreseen in the Standard Facility Specific terms. The ESM could disburse in cash or "in kind"[1]. ESM support could be leveraged at national and/or European level. Funds could be placed in an account, which ESM Members would use to back their guarantees or otherwise support investments by national development banks and/or relevant EIB initiatives (e.g. proposal for a pan-European guarantee fund or EIB capital increase).

Funding strategy: The ESM would fund the facilities as foreseen under the Diversified Funding Strategy (DFS) for cash disbursements. The ESM could finance the credit line through the issuance of "Social Stability Bonds". This could help the ESM attract a larger investor base, including the investors factoring in Environment, Social and Governance (ESG) criteria.

Pricing: The ESM would apply the existing Pricing Policy to calculate and charge its cost of funding and commitment fee. However, a fully disbursed ECCL under current pricing policy would cost 85.5 basis points on top of the cost of funding and the commitment fee, calculated on the outstanding amount.[2] With this in mind, the margin and/or the service fee included in the existing pricing would need to be lowered to reflect the purpose of the instrument.

Legal basis: This option could be implemented within the current ESM legal framework, as discussed in Annex 1.

[1] As in the current setting, ESM bonds provided as a disbursement "in kind" are subject so selling restrictions in financial markets to preserve the funding capacity of the ESM.
[2] 50 basis points are charged one-off at disbursement while the remaining 35.5 basis points are charged annually.

Annex 1: Conditions and eligibility (ECCL)

Conditions

The ESM Treaty requires that ESM stability support be subject to strict conditionality. At the same time, the ESM Treaty acknowledges that conditionality should be appropriate for the purpose of the instrument and provides flexibility on the substantive areas covered by conditionality. Under the ESM Treaty, conditionality shall be "appropriate to the financial assistance instrument chosen"[1] and "may range from a macro-economic adjustment programme to continuous respect of pre-established eligibility conditions"[2]. The content of the MoU is to reflect the severity of the weaknesses to be addressed and the nature of the shock that generates them, and the financial assistance instrument chosen.[3]

Conditionality also has to comply with EU law. The CJEU in its *Pringle* judgment explains the aim or purpose that conditionality must serve. *Pringle* provides that the purpose of ESM conditionality, and of Article 125 TFEU, is ultimately to ensure that the Member States follow a sound budgetary policy.[4]

Whether conditionality achieves the purpose of ensuring that Member States implement sound budgetary and economic policy depends on the circumstances and on the type of financial instrument chosen. In particular, it should depend on the nature of the problem that the ESM support seeks to address.

Under the current circumstances, the problem is the need to deliver a decisive and urgent response to the corona outbreak, both in terms of direct healthcare costs and in terms of the immediate economic costs of discretionary measures and automatic stabilisers. The measures are critical to limit damage to the economies of euro area Member States and the euro area as a whole. Failure to contain the coronavirus could jeopardise the financial stability of the euro area or of its Member States. In these exceptional circumstances, it is appropriate to devote very significant resources to this problem and introduce policy measures that will preserve productive capacity and hence avoid even greater costs and enable a faster recovery, and ultimately restore and preserve financial stability.

Accordingly, it is considered sufficient for the purposes of compliance with EU law and with the ESM Treaty that ESM support is conditional on the beneficiary Member committing (in an MoU, which could have common terms for all ESM Members requesting this facility) to apply its economic policy toward decisively addressing the economic consequences of the corona outbreak as rapidly as possible. If the credit line is drawn, ESM support should be used specifically for costs of responding to the corona outbreak (including health costs and economic costs). To ensure that this is done overall in a way that is consistent with sound budgetary policy and appropriate discipline, an ESM Member should also commit to continuous respect of the EU policy coordination and fiscal framework of the European Semester. This includes any flexibility applied by the competent EU institutions in response to an external shock.

Eligibility

ESM Members could decide that ESM precautionary support for the immediate response to the coronavirus outbreak would only be available in the form of an ECCL. This approach could be justified on the basis of the highly unpredictable economic effect of the coronavirus outbreak.

[1] Article 3 ESM Treaty
[2] Article 12(1) ESM Treaty
[3] Article 13(3) ESM Treaty
[4] *Pringle* paras 135-137, 143

If ESM Members wished to take this approach, it could be legally achieved by the BoG (by mutual agreement) when taking its decision to grant the precautionary credit line. What is legally necessary is to remain within the ESM Treaty requirements for the precautionary assistance instruments. The BoG decision would include the elements described above, describing that only an ECCL was available in the circumstances, and that only targeted corona-related conditionality would apply. Alternatively, the BoD could (by a qualified majority) set out the adjusted approach in the Guideline itself (which could be time-limited). In either case, this tailored approach to an ECCL would fully respect Article 14 of the ESM Treaty, which sets out the Treaty requirements for the precautionary assistance instruments.

Enhanced surveillance under Regulation (EU) No 472/2013 would apply from the time that the ECCL is granted, in response to concrete requests by Member States, to monitor implementation of the targeted coronavirus-related conditionality described above. The granting of the credit line would be subject to the three assessments in Article 13(1) of the ESM Treaty[1], which would be carried out as set out in the 'Procedural steps towards ESM Pandemic Crisis Support' of Annex 2. These requirements must be followed for any grant of ESM stability support.

[1] The required assessments are (a) the existence of the financial risk; (b) the DSA; and (c) the financing needs.

Annex 2: Procedural steps towards ESM Pandemic Crisis Support (ECCL)[1]

Step 1: Eurogroup [or Euro Summit] statement

- This statement sets out the coordinated and joint response to the corona virus by utilising the ESM in the spirit of solidarity between Member States and in parallel to initiatives deployed by other EU institutions and bodies like the Commission, the ECB and the EIB. It includes:
  - The collective, political endorsement by all euro area Members to enable the ESM to make available to all its Members the Pandemic Crisis Support, in accordance with the ESM Treaty, building on the framework of the existing Enhanced Conditions Credit Line (ECCL);
  - The agreement that significant resources should be allocated to Pandemic Crisis Support, around 2% of Member State GDP as a benchmark, which could be adjusted depending on the development of the pandemic;
  - The necessary standardised terms: conditions, as specified above, process to grant the credit lines as well as operational features, such as volume and maturity of the loans and their pricing.
- The Commission and the ECB, in collaboration with the ESM[2], would provide the three required assessments under Article 13(1) of the ESM Treaty for all euro area countries, based on existing data and information and on a preliminary (non-binding) basis.

Step 2. ESM BoG endorsement in principle of stability support availability for all ESM Members

Based on the Eurogroup [Euro Summit] statement, the ESM BoG:

- Endorses in principle the required stability support on the basis of the preliminary assessments provided by the institutions, and sets out the overall framework under which financial assistance will be made available. This includes providing a description of the template MoU, including the common terms regarding the targeted conditionality that will apply to any ECCL arrangement, and the template proposal for a Financial Facility Agreement (FFA) to be used for this purpose, based on a proposal by the ESM Managing Director.
- Invites the institutions to finalise their assessments as required under Article 13(1) of the ESM Treaty, in line with the assessments prepared in the context of the Eurogroup [Euro Summit] statement.

Step 3. Request for assistance

- Any ESM Member who wishes to access the ECCL sends its request for stability support in the context of Pandemic Crisis Support.

Step 4. BoG approval of stability support for each requesting ESM Member, including MoU and proposal for FFA

[1] It is noted that the suggested procedure in this note is at all times, where required, subject to the relevant national procedures of some ESM Members. The ESM's expectation is that these will be needed for some Members at Step 2, Step 4 and Step 5. The political statement in Step 1 must be drafted with this in mind.
[2] As per the Memorandum of Understanding in force between the Commission and the ESM.

- For each request, the BoG confirms that the framework as decided under step 2 will apply, and approves the in principle stability support to the requesting ESM Member on the basis of the following:

    - In line with the earlier assessments, the institutions confirm the assessments for the ESM Members who have requested assistance, as required under Article 13(1) of the ESM Treaty, on the basis that circumstances have not changed materially since the preliminary assessments.
    - The individual MoU's are finalised with the ESM Member and provided by the institutions, in line with the template MoU.
    - The individual proposals for FFA are approved based on the template proposal for an FFA as attached to the BoG Resolution approved under step 2.

- Each MoU is subsequently signed by the Commission (on behalf of the ESM), and the relevant Member, following the BoG approval.

Step 5. FFA

- The ESM BoD approves individual FFAs.

Annex 3: Rapid Financing Instrument (RFI)

Short description: Under this option, the ESM could set up a tailor-made Rapid Financing Instrument (RFI) accessible to provide financial support to ESM Members' emergency expenditures for healthcare and economic costs of natural disasters including pandemic crises.

Volume/Access: Access could be proportionate to Members' contributions to ESM paid-in capital with an overall envelope of about EUR 80 billion or another benchmark (e.g. severity of the coronavirus outbreak or identified financing needs). This would reflect the IMF approach to their equivalent facility. Alternatively, access could be on the same terms as for the Pandemic Crisis Support ECCL.

Eligibility: Emergency ESM support would be made available to all ESM Members affected by a natural disaster or equivalent extreme external event, significantly affecting their economic policies and financial stability.

Conditions: ESM support can only be used to finance health and economic cost of emergency response. In addition, respect of EU fiscal rules and European Semester would need to be ensured, including any flexibility applied by the competent EU institutions. These measures would be specified in an "Economic response plan", which would constitute the MoU for the purposes of the ESM Treaty.

Availability period/Maturities: Availability would be limited to one-year. Average maturity of 3-5 years, giving sufficient time to absorb the economic shock. This would be a non-revolving credit line. Setting maturities would need to take into account practical feasibility from the ESM's funding perspective.

Disbursements: Once granted, the ESM Members could draw from the credit line according to agreed modalities, which could be similar as for the PCCL/ECCL.

Pricing: The ESM would apply the existing Pricing Policy to calculate and charge its cost of funding and commitment fee. New pricing elements (e.g. margin, service fee) to be developed in accordance with the purpose of the instrument. For example, the existing pricing policy already foresees the possibility to apply a lower service fee to short term loans, which could be applied under RFI.

Funding strategy: The ESM would fund the RFI as foreseen under the Diversified Funding Strategy (DFS) for cash disbursements. The ESM could finance the credit line by issuing bonds according to Environmental, Social, Governance (ESG) principles.

Support of development loans: ESM support could be leveraged at national and/or European level. Funds could be placed in an account at national level, which ESM Members would use to back their guarantees or could be used by Member States to support relevant EIB initiatives (e.g. proposal for a pan-European guarantee fund or EIB capital increase).

Legal basis: A new instrument to be introduced in accordance with the ESM Treaty using Article 19. It would require a decision by mutual agreement of the Board of Governors (BoG) and preparation of new legal documents (e.g. BoG resolution, instrument guideline, and lending documentation would be required. These would be based on the documentation for existing credit lines, to accelerate the drafting process.