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WORKING PAPER SERIES
No 2015/13

**THE EUROPEAN STABILITY MECHANISM
DIRECT RECAPITALISATION INSTRUMENT:
AN ELEMENT FOR A COMPLETE EUROPEAN
BANKING UNION**

by Ph.D. Candidate Dimitris Vovolinis

March 2015

WORKING PAPER SERIES
No 13 / March 2015

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AN ELEMENT FOR A COMPLETE EUROPEAN
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The European Stability Mechanism Direct Recapitalisation Instrument: An element for a complete European Banking Union

Dimitris Vovolinis*

March 2015

Abstract

The European Stability Mechanism ('ESM') is a permanent crisis resolution mechanism for the countries of the euro area, which started operating in 8 October 2012. It is an important component of the comprehensive EU strategy designed to safeguard financial stability within the euro area. To that end, it issues debt instruments in order to finance loans and other forms of financial assistance to euro area Member States facing adverse financial conditions.

The present working paper, structured in three (3) sections, explores the role of the Direct Recapitalisation Instrument of the ESM within the context of the European Banking Union. Section A provides an overall examination of the ESM, and Section B deals with the provisions on the key elements of the Guideline pertaining to the Direct Recapitalisation Instrument and its integration within the institutional framework of the European Banking Union. Section C contains some concluding remarks.

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* The author wishes to thank Professor Christos Gortsos for his valuable comments and suggestions and Panagiota Tzamourani for the editing of the text.

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List of Abbreviations

| | |
|-----------------|--|
| BRRD | Bank Recovery and Resolution Directive (2014/59/EU) |
| CRD IV | Capital Requirements Directive no. IV (2013/36/EU) |
| CRR | Capital Requirements Regulation (575/2013) |
| DGSD | Deposit Guarantee Scheme Directive (2014/49/EU) |
| DRI | Direct Recapitalisation Instrument |
| EBA | European Banking Authority |
| EBU | European Banking Union |
| ECB | European Central Bank |
| ECCL | Enhanced Conditions Credit Line |
| EFC | Economic and Financial Committee |
| EFSF | European Financial Stability Facility |
| EFSM | European Financial Stabilisation Mechanism |
| EMU | Economic and Monetary Union |
| ESCB | European System of Central Banks |
| ESM | European Stability Mechanism |
| EU | European Union |
| FSAP | Financial Sector Assessment Programme |
| FSB | Financial Stability Board |
| IMF | International Monetary Fund |
| MIFID I | Markets in Financial Instruments Directive no. I (2004/39/EC) |
| MIFID II | Markets in Financial Instruments Directive no. II (2014/65/EU) |
| MoU | Memorandum of Understanding |
| OJ | Official Journal of the European Union |
| PCCL | Precautionary Conditioned Credit Line |
| SDGS | Single Deposit Guarantee Scheme |
| SGP | Stability and Growth Pact |
| SRF | Single Resolution Fund |
| SRM | Single Resolution Mechanism |
| SSM | Single Supervisory Mechanism |
| TEC | Treaty establishing the European Community |
| TEU | Treaty on European Union |
| TFEU | Treaty on the Functioning of the European Union |
| TSCG | Treaty on Stability, Coordination and Governance |

A. Introductory Remarks

1. General aspects

(a) The European Stability Mechanism¹ (hereinafter the ‘ESM’), established through an Intergovernmental Treaty signed by nineteen (19) Member States, whose currency is the euro,² is an international³ financial institution,⁴ under (public) international law, with its seat and principle office located in Luxembourg.⁵

(b) Its legal basis⁶ is the (new) **paragraph 3** of **Article 136** of the Treaty on the Functioning of the European Union⁷ (hereinafter the ‘TFEU’), which reads as follows:

*‘The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality’.*⁸

*The above-mentioned (new) paragraph was inserted through the adoption by the European Council of **Decision 2011/199/EU**,⁹ in accordance with the simplified amendment procedure¹⁰ of the Treaties, laid down in **Article 48, paragraph 6** of the Treaty on European Union¹¹ (hereinafter the ‘TEU’).*

(c) Its purpose is to mobilise funding and provide stability support under strict economic policy conditionality,¹² appropriate to the financial assistance instrument

¹ The ESM was inaugurated on 8 October 2012 and, according to Recital 1 (second sentence) of its Treaty, it is considered the legal successor of the European Financial Stability Facility (hereinafter the ‘EFSF’) and the European Financial Stabilisation Mechanism (hereinafter the ‘EFSM’) in providing, where and if needed, financial assistance to euro area Member States.

For more details on the EFSM and the EFSF, *see* indicatively **Sibert (2010)**, the various contributions in **Wyplosz, Collignon, Gros and Belke (2011)**, **Caminal (2012)**, pp. 5-13, **Gocaj and Meunier (2013)**, pp. 240-247 and **Stephanou (2013)**, pp. 132-134.

² **ESM Treaty**, Article 1, paragraph 2 and Recital 7. The term ‘euro area Member States’ denotes Member States, whose currency is the euro, according to the provisions laid down in Article 136 TFEU (OJ C 326, 26.10.2012, p. 106).

³ In the author’s opinion, the use of the term ‘international’ is not accurate, given the fact that the ESM, as explained further in this working paper, can provide financial assistance only to euro area Member States. Instead, the term ‘regional’ is considered more appropriate.

⁴ **ESM Treaty**, Article 1, paragraph 1.

⁵ *Ibid.*, Article 31, paragraph 1. It maintains the option to establish a liaison office in Brussels, if needed (*Ibid.*, Article 31, paragraph 2).

⁶ For a general overview of its legal foundation, as well as those of its predecessors and the legal tensions that have arisen amidst the current fiscal crisis within the eurozone, *see* indicatively **Ryvkin (2012)**, pp. 228-255 and **Stratigopoulou and Mylonakis (2013)**, pp. 18-22.

⁷ OJ C 326, 26.10.2012, pp. 47-329.

⁸ **ESM Treaty**, Recital 2 *in finem* and **Decision 2011/199/EU**, Article 1.

⁹ OJ L 91, 6.4.2011, pp. 1-2.

¹⁰ On this procedure, as well as the legal and judicial implications that have arisen due to the ratification process, *see* indicatively **Barrett (2011)**, **Smits (2012)**, **Borger (2013)** and **Schiavo (2013)**, pp. 8-22.

¹¹ OJ C 326, 26.10.2012, pp. 13-45.

¹² As of 1 March 2013, the granting of financial assistance in the framework of new programmes under the ESM will be conditional:

chosen to the benefit of its members, which are experiencing, or are threatened by, severe financing problems, if indispensable to safeguard the stability of the euro area as a whole and of its Member States. In order to achieve this, the ESM is entitled to raise funds:

- by issuing financial instruments,
- by entering into financial agreements and arrangements with its members,
- by entering into financial agreements and arrangements with financial institutions, or
- by entering into financial agreements and arrangements with other third parties.¹³

In terms of the economic policy conditionality principle¹⁴ accompanying the financial assistance provided, it may range from a macroeconomic adjustment programme to continuous respect of pre-established eligibility conditions.¹⁵ This was explicitly confirmed during the meeting of the Heads of State or Government comprising the euro area on 21 July 2011.¹⁶ Accordingly, **Recital 3** of the **ESM Treaty** states in this respect:

‘With a view to increasing the effectiveness of the financial assistance and to prevent the risk of financial contagion, the Heads of State or Government of the Member States whose currency is the euro agreed on 21 July 2011 to increase the flexibility of the ESM linked to appropriate conditionality’.

(d) Its authorised capital stock amounts to 704.8 billion euros.¹⁷ It is divided into paid-in shares, the initial total aggregate nominal value of which amounts to 80.55 billion euros, and to callable guarantees amounting to 624.25 billion euros.¹⁸ The nominal value of each share amounts to 100.000 euros, available for subscription

-
- on the ratification of the so-called Treaty on Stability, Coordination and Governance (known as the ‘TSCG’, or the ‘Fiscal Compact’) by the ESM Member concerned, and
 - upon expiration of the transposition period referred to in Article 3, paragraph 2 therein on compliance with the requirements of that Article (**ESM Treaty**, Recital 5, fourth sentence).

For a detailed analysis of the TSCG and its close correlation with the ESM, *see* indicatively **European Central Bank (2012)**, pp. 79-94, **Fabbrini (2013)**, pp. 1-38, **Lastra (2013)**, pp. 68-71 and **Stephanou (2013)**, pp. 149-151.

¹³ **ESM Treaty**, Articles 3 and 12, first sentence, and Recital 6, second sentence.

¹⁴ Within the field of political economy and international relations in general, conditionality is the use of conditions attached to the provision of benefits such as a loan, debt relief or bilateral aid. These conditions are typically imposed by international financial institutions (such as the International Monetary Fund) or regional institutions (such as the ESM) and are intended to improve economic conditions within the beneficiary country.

For more details on the nature of the economic policy conditionality clause, *see* indicatively **Dreher (2009)**, pp. 233-267.

¹⁵ **ESM Treaty**, Article 12, paragraph 1, second sentence.

¹⁶ **Euro Area Summit Statement, 21 July 2011**, paragraph 8, available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/123978.pdf

¹⁷ **ESM Treaty**, Article 8, paragraph 1, first sentence.

¹⁸ *Ibid.*, Article 8, paragraph 2, first and second sentences.

according to the initial contribution key provided for in **Article 11** of the **ESM Treaty** and calculated in the relevant Annex therein.¹⁹

The shares of the authorised capital stock are not encumbered or pledged in any manner whatsoever and they are not transferable, with the exception of transfers for the purposes of implementing adjustments of the contribution key provided for in **Article 11** therein to the extent necessary to ensure that the distribution of shares corresponds to the adjusted key.²⁰

The liability of each Member State is limited, in all circumstances, to its portion of the authorised capital stock at its issue price. No Member State is held liable, by reason of its membership, for obligations of the ESM. The obligations of them to contribute to the authorised capital stock, in accordance with the provisions laid down in the ESM Treaty are not affected if any such Member State becomes eligible for, or is receiving, financial assistance from the ESM.²¹

*On the current Member States contributions towards the ESM, see below **Table 1**.*

(e) Its initial effective lending capacity is set at 500 billion euros, including the outstanding EFSF stability support.²² Nevertheless, the adequacy of the consolidated ESM and EFSF lending volume was reassessed prior to the entry into force of its Treaty.²³ The Statement of the Eurogroup²⁴ meeting on 30 March 2012 was firm on this (second sub-paragraph):

*'In order to further improve market confidence (...) we have reassessed the adequacy of the overall EFSF/ESM lending ceiling of 500 billion euros which, given 200 billion euros long term commitments of the EFSF, currently entails a 300 billion euros maximum lending volume for the ESM.'*²⁵

Nevertheless, its lending capacity may be increased, if needed, through an adoption of a formal Decision taken by the Board of Governors (on this body *see* below, under 2.2.1), in accordance with the provisions laid down in **Article 10** of the **ESM Treaty**.²⁶

¹⁹ *Ibid.*, Articles 8 (paragraph 1, second sentence) and 9 (paragraph 2). The contribution key of each ESM Member is included in Annex I therein. It is based on the key for subscription, by the National Central Banks of the ESM Members, of the ECB's capital pursuant to the provisions laid down in **Article 29** of **Protocol (No 4)** on the Statute of the European System of Central Banks and of the European Central Bank (the 'ESCB Statute') annexed to the **TEU** and to the **TFEU** (OJ C 326, 26.10.2012, pp. 230-250).

²⁰ **ESM Treaty**, Article 8, paragraph 3.

²¹ *Ibid.*, Article 8, paragraph 5.

²² *Ibid.*, Recital 6, third sentence.

²³ *Ibid.*, Recital 6, fourth sentence.

²⁴ The Eurogroup, the main forum for the management of the single currency area, is an informal body that brings together the finance ministers of countries, whose currency is the euro. Its role is to ensure close coordination of economic policies within the euro area. It also aims to promote conditions for stronger economic growth, as well as to promote financial stability. Its legal basis is **Article 137 TFEU**, further specified in **Protocol (No 14)** annexed to the **TEU** and to the **TFEU** (OJ C 326, 26.10.2012, p. 107 and p. 283 respectively).

For a general overview of the role of this body, *see* **Lastra (2013)**, pp. 37-38.

²⁵ This Statement is available at:

http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/129381.pdf

²⁶ **ESM Treaty**, Recital 6, fifth sentence.

(f) Finally, its Treaty entered into force on the date when the instruments of ratification, approval or acceptance have been deposited by signatories, whose initial subscriptions represent no less than 90% of the total subscriptions set forth in the relevant Annex therein.²⁷ This was explicitly confirmed during the meeting of the Heads of State or Government comprising the euro area on 9 December 2011. Accordingly:

'The Treaty will enter into force as soon as Member States representing 90% of the capital commitments have ratified it'.²⁸

*It is worth pointing out, however, that the original text of the **ESM Treaty** was signed (and subsequently ratified, according to the relevant national procedures) by seventeen (17) Member States on 2 February 2012. Latvia and Lithuania, which joined the euro area on 1 January 2014 and 1 January 2015 respectively, became the 18th Member and 19th Member of the ESM on 13 March 2014 and 3 February 2015 respectively, following the deposit of the 'instrument of accession' (i.e. the national legal act confirming ratification of the **ESM Treaty**), in accordance with the procedure referred to in **Article 48, paragraph 3** therein.*

²⁷ *Ibid.*, Article 48, paragraph 1, first sentence. In Greece, it has been ratified by **Law 4063/2012**.

²⁸ **Euro Area Summit Statement, 9 December 2011**, paragraph 13, second sentence, available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/126658.pdf.

| TABLE 1 | | | |
|---|-----------------------------|-----------------------------------|------------------------------|
| The ESM shareholder contributions (as of March 2015) | | | |
| Member State | Contribution Key (%) | Capital Subscription (€bn) | Paid-in Capital (€bn) |
| Austria | 2.7757 | 19.48 | 2.23 |
| Belgium | 3.4675 | 24.34 | 2.78 |
| Cyprus | 0.1957 | 1.37 | 0.16 |
| Estonia | 0.1855 | 1.30 | 0.15 |
| Finland | 1.7924 | 12.58 | 1.44 |
| France | 20.3297 | 142.70 | 16.31 |
| Germany | 27.0716 | 190.02 | 21.72 |
| Greece | 2.8089 | 19.72 | 2.25 |
| Ireland | 1.5878 | 11.15 | 1.27 |
| Italy | 17.8643 | 125.40 | 14.33 |
| Latvia | 0.2757 | 1.935 | 0.22 |
| Lithuania | 0.4063 | 2.86 | 0.33 |
| Luxembourg | 0.2497 | 1.75 | 0.20 |
| Malta | 0.0729 | 0.51 | 0.06 |
| Netherlands | 5.7012 | 40.02 | 4.57 |
| Portugal | 2.5023 | 17.56 | 2.01 |
| Slovakia | 0.8217 | 5.77 | 0.66 |
| Slovenia | 0.4264 | 2.99 | 0.34 |
| Spain | 11.8709 | 83.33 | 9.52 |
| Total | 100% | 704.8 | 80.55 |

2. Institutional provisions

2.1 Legal status

(a) In order to fulfil its purpose (*see* above, under 1(c)), the legal status, as well as the privileges and immunities are accorded to the ESM in the territory of each of its Member. Furthermore, the ESM must endeavour to obtain recognition of its legal status and of its privileges and immunities in other territories, in which it performs functions or holds assets.²⁹

(b) It maintains full legal personality, thus allowing to:

- acquire and dispose of movable and immovable property,
- contract,
- be a party to legal proceedings, and
- enter into a headquarter agreement and/or protocols as necessary for ensuring that its legal status and its privileges and immunities are recognised and enforced.³⁰

(c) As a general rule and to the extent necessary to carry out its activities provided for in its Treaty, all property, funding and assets of the ESM are free from restrictions, regulations, controls and moratoria of any nature.³¹ Moreover, its property, funding and assets, wherever located and by whomsoever held, enjoy immunity in the following cases:

- from every form of judicial process,
- from search, requisition, confiscation, expropriation, and/or
- any other form of seizure, taking or foreclosure by executive, judicial, administrative or legislative action.³²

This holds without prejudice to the extent that the ESM expressly waives its immunity for the purpose of any proceedings or by the terms of any contract, including the documentation of the funding instruments.³³

(d) The archives and all documents belonging to the ESM or held by it, as well as its premises are considered inviolable.³⁴

(e) Its official communications are accorded by each of its Member and by each state, which has recognised the legal status and the privileges and immunities of the ESM, the same treatment as it accords to the official communications of another ESM Member.³⁵

(f) Finally, it is exempted from any requirement to be authorised or licensed as:

²⁹ **ESM Treaty**, Article 32, paragraph 1.

³⁰ *Ibid.*, Article 32, paragraph 2.

³¹ *Ibid.*, Article 32, paragraph 8.

³² *Ibid.*, Article 32, paragraph 4.

³³ *Ibid.*, Article 32, paragraph 3.

³⁴ *Ibid.*, Article 32, paragraphs 5 and 6.

³⁵ *Ibid.*, Article 32, paragraph 7.

- a credit institution,³⁶
- an investment services provider,³⁷ and/or
- any other authorised, licensed or regulated entity under the provisions of the relevant national law of each of its Member.³⁸

2.2 Governance

In order to accomplish its purpose, as mentioned above (under 1(c)), the ESM disposes:

- a Board of Governors (*see* below, under 2.2.1),
- a Board of Directors (*see* below, under 2.2.2),
- a Managing Director (*see* below, under 2.2.3), and
- other dedicated staff, as considered necessary (*see* below, under 2.2.4).³⁹

³⁶ According to Article 4, paragraph 1, point (1), of **Regulation (EU) No 575/2013** of the European Parliament and of the Council of 26 June 2013 ‘*on prudential requirements for credit institutions and investment firms (...)*’ (OJ L 176, 27.6.2013, pp. 1-337) (known as the ‘Capital Requirements Regulation’ or the ‘CRR’), a credit institution means ‘*an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account*’.

It is worth pointing out that this definition was introduced for the first time in 1977 by Article 1 (first indent) of the so-called ‘First Banking Directive’ (**First Council Directive 77/880/EC** of 12 December 1977 ‘*on the coordination of the laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions*’ (OJ L 322, 17.12.1977, pp. 30-37)) and has remained unchanged ever since.

The CRR, alongside **Directive 2013/36/EU** of the European Parliament and of the Council of 26 June 2013 ‘*on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (...)*’ (OJ L 176, 27.6.2013, pp. 338-436) (known as the ‘Capital Requirements Directive IV’ or the ‘CRD IV’), reflect to a large extent the framework of the Basel Committee on Banking Supervision of 2010 (following the recent (2007-2009) international financial crisis, as in force, in this field (the ‘Basel III regulatory framework’)). For more details on the Basel III regulatory framework, *see* indicatively **Gortsos (2011a)** and **Gortsos (2012a)**, pp. 254-281.

³⁷ In the author’s opinion, the use of the term ‘investment services provider’ is not accurate. Instead, the term ‘investment firm’ is considered more appropriate. According to Article 4, paragraph 1, point (1), of **Directive 2004/39/EC** of the European Parliament and of the Council of 21 April 2004 ‘*on markets in financial instruments (...)*’ (OJ L 145, 30.4.2004, pp. 1-44) (known as ‘MIFID I’), an investment firm means ‘*any legal person whose regular occupation or business is the provision of one or more investment services to third parties, and/or the performance of one or more investment activities on a professional basis*’.

The terms ‘investment services’ and ‘activities’ are further defined as any of the services and activities listed in Section A of Annex I, related to any of the instruments listed in Section C of Annex I of the MIFID I.

It is worth pointing out that the above-mentioned Directive will be repealed with effect from 3 January 2017 by **Directive 2014/65/EU** of the European Parliament and of the Council of 15 May 2014 ‘*on markets in financial instruments (...)*’ (OJ L 173, 12.6.2014, pp. 349-496) (known as ‘MIFID II’).

³⁸ **ESM Treaty**, Article 32, paragraph 9.

³⁹ *Ibid.*, Article 4, paragraph 1. *See* on this **European Central Bank (2011a)**, pp. 75-76 and **Stratigopoulou and Mylonakis (2013)**, pp. 22-25.

2.2.1 The Board of Governors

2.2.1.1 Introductory remarks

(a) The planning and execution of the majority of the tasks conferred upon the ESM by its Treaty is undertaken by the *hierarchically supreme decision-making body*, the Board of Governors.

(b) Each ESM Member appoints a Governor and an alternate Governor.⁴⁰ The Governor must (always) be a member of the national government of each ESM Member, responsible for the management of economic policy.⁴¹ The alternate Governor must have full power to act on behalf of the Governor, when the *latter* is not present.⁴² If needed, such appointments are revocable at any time.⁴³

(c) The Member of the European Commission in charge of economic and monetary affairs (i.e. the European Commissioner for Economic and Monetary Affairs), the President of the European Central Bank (hereinafter the ‘ECB’), as well as the President of the Eurogroup (if he/she is not the Chairperson or a Governor of an ESM Member) may participate in the meetings of the Board of Governors as observers.⁴⁴

On an *ad hoc* basis, other persons, including representatives of international institutions or organisations, such as the International Monetary Fund⁴⁵ (hereinafter the ‘IMF’) may be invited by the Board of Governors to attend its meetings.⁴⁶ In addition, representatives of non-euro area Member States participating on an *ad hoc* basis alongside the ESM in a stability support operation for a euro area Member State, must also be invited to participate, as observers, in the meetings of the Board of Governors, when this stability support and its subsequent monitoring is to be discussed.⁴⁷

Additional detailed provisions regarding the attendance at the meetings of the Board of Governors are included in Article 3 of its Rules of Procedure.

On the current composition of the Board of Governors, see below Table 2.

(d) The Board of Governors, through the adoption of a formal Decision can be chaired:

- by the President of the Eurogroup, or
- by a Chairperson and a Vice-Chairperson, elected from among its members, each for a (renewable) term of two (2) years.⁴⁸

⁴⁰ **ESM Treaty**, Article 5, paragraph 1, first sentence. The first designations by the ESM Members regarding their respective Governors and alternate Governors were made within two (2) weeks of the entry into force of the ESM Treaty (*Ibid.*, Article 43, paragraph 1).

⁴¹ *Ibid.*, Article 5, paragraph 1, third sentence.

⁴² *Ibid.*, Article 5, paragraph 1, fourth sentence.

⁴³ *Ibid.*, Article 5, paragraph 1, second sentence.

⁴⁴ *Ibid.*, Article 5, paragraph 3.

⁴⁵ On the cooperation regime between the ESM and the IMF, *see* below, under 3.5.

⁴⁶ **ESM Treaty**, Article 5, paragraph 5.

⁴⁷ *Ibid.*, Article 5, paragraphs 4. Of relevant importance is also the content of Recital 9.

⁴⁸ **ESM Treaty**, Article 5, paragraph 2, first and second sentences and **ESM By-Laws**, Article 2.

In the *latter* case, a new election process must be organised, without undue delay, in case the incumbent no longer holds the function needed for being designated Governor.⁴⁹

As of March 2015, the ESM Board of Governors is chaired by the Minister of Finance of the Netherlands and, subsequently, President of the Eurogroup, Jeroen Dijsselbloem. He succeeded the (former) Prime Minister of Luxembourg and (former) President of the Eurogroup, and (as of 1 November 2014) President of the European Commission, Jean-Claude Juncker.

(e) The Chairperson must convene and preside over the meetings of the Board of Governors.⁵⁰ Whereas he/she is unable to participate, the Vice-Chairperson must preside over these meetings.⁵¹

Detailed provisions regarding the meetings of the Board of Governors are included in Article 3 of the ESM By-Laws, as well as in Articles 2, 4, 5, 6, 7 and 10 of its Rules of Procedure.

(f) Finally, it is responsible for the adoption of the relevant Rules of Procedure and the By-Laws of the ESM.⁵²

The Rules of Procedure of the Board of Governors, as well as the By-Laws of the ESM were both adopted on 8 October 2012, on the day the ESM was inaugurated. As of March 2015, the By-Laws of the ESM have been amended once (on 8 December 2014), in order to reflect the internal changes following the adoption of the Direct Recapitalisation Instrument (the 'DRI'). On the contrary, the Rules of Procedure of the Board of Governors, have not (yet) been amended.

2.2.1.2 Procedural provisions

(a) As specified in the ESM Treaty, the Decisions of the Board of Governors must be taken:⁵³

- by **mutual agreement** (i.e. 'unanimity'),⁵⁴
- by **qualified majority** (requiring 80% of the votes cast),⁵⁵ or
- by **simple majority** (requiring the majority of the votes cast).⁵⁶

As a general principle and in respect of all Decisions, a quorum of 2/3 of the Members with voting rights representing (at least) 2/3 of the voting rights must be present, during its meetings.⁵⁷

⁴⁹ ESM Treaty, Article 5, paragraph 2, third sentence.

⁵⁰ *Ibid.*, Article 5, paragraph 8, first sentence.

⁵¹ *Ibid.*, Article 5, paragraph 8, second sentence.

⁵² *Ibid.*, Article 5, paragraph 9.

⁵³ *Ibid.*, Article 4, paragraph 2, first sentence.

⁵⁴ It is worth pointing out that the adoption of a Decision by mutual agreement requires the unanimity of the Members participating in the voting procedure. Abstentions do not prevent the adoption of a Decision by mutual agreement (*Ibid.*, Article 4, paragraph 3).

⁵⁵ *Ibid.*, Article 4, paragraph 5.

⁵⁶ *Ibid.*, Article 4, paragraph 6.

⁵⁷ *Ibid.*, Article 4, paragraph 2, second sentence.

*By way of derogation from the above-mentioned, an emergency voting procedure must be used whereas the European Commission and the ECB both conclude that a failure to urgently adopt a Decision to grant or implement financial assistance, as defined in **Articles 13-18** of the **ESM Treaty**, would threaten the economic and financial sustainability of the euro area as a whole. If such a case prevails, the adoption of a Decision by mutual agreement by the Board of Governors, under that emergency procedure requires a **qualified majority of 85% of the votes cast**.*⁵⁸

*Article 8 of the **ESM By-Laws** contains additional detailed provisions regarding this procedure.*

(b) The voting rights of each Member, as exercised by its appointee or by the latter's representative on the Board of Governors, according to the above-mentioned (under 2.2.1.1(b)), must be equal to the number of shares allocated to it in the authorised capital stock of the ESM, as set out in the relevant Annex of the **ESM Treaty**.⁵⁹

*Detailed provisions regarding the voting procedure of the Board of Governors are included in **Article 4** of the **ESM By-Laws**, as well as in **Articles 8, 9 and 11** of its **Rules of Procedure**.*

(c) In exceptional cases, if any ESM Member fails to pay (in whole or in part) the amount in respect of its obligations in relation to paid-in shares and/or calls of capital under the provisions laid down in **Articles 8, 9 and 10** of the **ESM Treaty**, or in relation to the reimbursement of the financial assistance under the provisions laid down in **Articles 16 or 17** therein, such Member must be unable, for the time period that such failure continues to apply, to exercise any of its voting rights.⁶⁰ Subsequently, the voting thresholds must be recalculated accordingly.⁶¹

(d) According to **Article 5, paragraph 6** of the **ESM Treaty**, the Board of Governors must, *inter alia*, take the following Decisions by **mutual agreement** (i.e. 'unanimity'):

- to cancel the emergency reserve fund and transfer its content back to the reserve fund and/or the paid-in capital, in accordance with the procedure laid down in **Article 4, paragraph 4 (second sub-paragraph)** (*see* just above, under (a)),
- to issue new shares on terms other than at par, in accordance with **Article 8, paragraph 2 (fourth sentence)**,
- to make the capital calls, in accordance with **Article 9, paragraph 1**,
- to change the authorised capital stock and adapt the maximum lending capacity of the ESM, in accordance with **Article 10, paragraph 1 (first and second sentences)** (*see* above, under 1(e)),
- to take into account a possible update of the contribution key for the subscription of the ECB capital, in accordance with **Article 11, paragraph 4**, as well as the changes to be made to the relevant Annex, in accordance with **Article 11, paragraph 6**,

⁵⁸ *Ibid.*, Article 4, paragraph 4, first sub-paragraph.

⁵⁹ *Ibid.*, Article 4, paragraph 7.

⁶⁰ *Ibid.*, Article 4, paragraph 8, first sentence.

⁶¹ *Ibid.*, Article 4, paragraph 8, second sentence.

- to provide stability support by the ESM, including the economic policy conditionality as stated in the relevant Memorandum of Understanding (the ‘MoU’) referred to in **Article 13, paragraph 3 (first sub-paragraph)**, and to establish the choice of instruments, as well as the financial terms and conditions, in accordance with the provisions laid down in **Articles 12 to 18** (*see below*, under B, 1(c)),
- to give a mandate to the European Commission to negotiate, in liaison with the ECB, the economic policy conditionality attached to each financial assistance, in accordance with the procedure laid down in **Article 13, paragraph 3 (first sub-paragraph)** (*see below*, under B, 1(d)),
- to change the pricing policy and amend the relevant pricing guideline for financial assistance, in accordance with the provisions referred to in **Article 20**,
- to amend the list of financial assistance instruments that may be used by the ESM, in accordance with **Article 19** (*see below*, under B, 3.1(b)),
- to establish the modalities of the transfer of the EFSF support to the ESM, in accordance with the procedure laid down in **Article 40, paragraph 3** (*see below*, under 3.6.2(c)),
- to approve the application for membership of the ESM by new Members, referred to in **Article 44**,
- to make adaptations to the ESM Treaty as a direct consequence of the accession of new Members, including changes to be made to the distribution of capital among its Members and the calculation of such a distribution as a direct consequence of the accession of a new Member to the ESM, in accordance with the provisions laid down in **Article 44**, and
- to delegate to the Board of Directors the tasks listed in **Article 5**.⁶²

(e) Subsequently, according to **Article 5, paragraph 7** of the **ESM Treaty**, the Board of Governors must, *inter alia*, take the following Decisions by **qualified majority** (i.e. 80% of the votes cast):

- to set out the detailed technical terms of accession of a new Member to the ESM, in accordance with the provisions laid down in **Article 44**,
- whether to be chaired by the President of the Eurogroup or to elect the Chairperson and Vice-Chairperson, in accordance with the procedure mentioned above (under 2.2.1.1(d)),
- to set out its Rules of Procedure (including the right to establish committees and subsidiary bodies)⁶³ and the By-Laws of the ESM, in accordance with the above-mentioned (under 2.2.1.1(f)),

⁶² **ESM By-Laws**, Article 5, paragraph 1. It is worth pointing out that the Board of Directors shall not take any action pursuant to powers delegated to it which is inconsistent with any action taken by the Board of Governors. Subsequently, the *latter* retains full power to exercise authority over any matter delegated to the Board of Directors, if needed (*Ibid.*, Article 5, paragraphs 2 and 3 respectively).

⁶³ According to Article 12 (*Ibid.*): ‘*The Board of Governors (...), acting by qualified majority, may (...) establish such permanent or ad hoc committees or subsidiary bodies as it considers necessary or appropriate to advise or otherwise assist (...) in the performance of its respective duties. The Board of Governors shall define the tasks, composition and operating rules of such committees or subsidiary bodies.*’

- to determine the list of activities incompatible with the duties of a Director or an alternate Director, in accordance with the procedure laid down in **Article 6, paragraph 8** (*see* below, under 2.2.2.1(e)),
- to appoint and to end the term of office of the Managing Director, in accordance with **Article 7, paragraph 2** (*see* below, under 2.2.3.1(b)),
- to establish other funds, in accordance with the provisions laid down in **Article 24, paragraph 1**,
- on the actions to be taken for recovering a debt from a Member, in accordance with the procedure laid down in **Article 25, paragraphs 2 and 3**,
- to approve the annual accounts of the ESM, in accordance with the provisions referred to in **Article 27, paragraph 1**,
- to appoint the members of the Board of Auditors, according to the procedure of **Article 30, paragraph 1** (*see* below, under 2.2.4.1.1(b)),
- to approve the external auditors, in accordance with **Article 29** (*see* below, under 2.2.4.1.2(a)),
- to waive the immunity of:
 - its Chairperson,
 - a Governor,
 - an alternate Governor,
 - a Director,
 - an alternate Director, or
 - the Managing Director, in accordance with the provisions referred to in **Article 35, paragraph 2** (*see* below, under 3.2(b)),
- to determine the taxation regime applicable towards the ESM dedicated staff, in accordance with the procedure laid down in **Article 36, paragraph 5 (first sentence)** (*see* below, under 3.3(c)),
- on a dispute, in accordance with the provisions referred to in **Article 37, paragraph 2 (first sentence)** (*see* below, under 3.4(b)), and
- any other necessary Decision not explicitly provided for by the **ESM Treaty**.

| TABLE 2 | | |
|---|---|---------------------------|
| The composition of the ESM Board of Governors (as of March 2015) | | |
| Member State | Governor | Alternate Governor |
| Austria | Hans Jörg Schelling | Harald Waiglein |
| Belgium | Johan Van Overtveldt | Marc Monbaliu |
| Cyprus | Harris Georgiades | Christos Patsalides |
| Estonia | Maris Lauri | Märten Ross |
| Finland | Antti Rinne | Tuomas Saarenheimo |
| France | Michel Sapin | Bruno Bézard |
| Germany | Wolfgang Schäuble | Thomas Steffen |
| Greece | Yanis Varoufakis | George Chouliarakis |
| Ireland | Michael Noonan | Nicholas O'Brien |
| Italy | Pier Carlo Padoan | Vincenzo La Via |
| Latvia | Jānis Reirs | Baiba Bāne |
| Lithuania | Rimantas Šadžius | Algimantas Rimkūnas |
| Luxembourg | Pierre Gramegna | Isabelle Goubin |
| Malta | Edward Scicluna | Alfred Camilleri |
| Netherlands | Jeroen Dijsselbloem | Hans Vijlbrief |
| Portugal | Maria Luís Casanova Morgado Dias de Albuquerque | Isabel Castelo Branco |
| Slovakia | Peter Kažimír | Vazil Hudak |
| Slovenia | Dušan Mramor | Irena Sodin |
| Spain | Luis de Guindos Jurado | Rosa María Sánchez Yebra |

The European Commissioner for Economic and Monetary Affairs (Pierre Moscovici) and the President of the ECB (Mario Draghi) may participate in the meetings of the ESM Board of Governors as observers.

On an ad hoc basis, other persons, including representatives of international institutions or organisations, such as the IMF may be invited by the Board of Governors to attend its meetings.

In addition, representatives of non-euro area Member States participating on an ad hoc basis alongside the ESM in a stability support operation for a euro area Member State, must also be invited to participate, as observers, in the meetings of the Board of Governors, when this stability support and its subsequent monitoring is to be discussed.

The ESM Board of Governors is chaired by the President of the Eurogroup (Jeroen Dijsselbloem).

2.2.2 The Board of Directors

2.2.2.1 Introductory remarks

(a) The execution of specific tasks conferred upon the ESM by its Treaty is undertaken (through proper delegation by the Board of Governors) by the *second decision-making body*, the Board of Directors.

(b) Each Governor appoints one Director and one alternate Director from among people of high competence in economic and financial matters.⁶⁴ Each Director and alternate Director must devote to the activities of the ESM such time and attention as the interest of the institution may require.⁶⁵ The alternate Directors must have full power to act on behalf of the Director, when the *latter* is not present.⁶⁶ If needed, such appointments are revocable at any time.⁶⁷

(c) The Member of the European Commission in charge of economic and monetary affairs (i.e. the European Commissioner for Economic and Monetary Affairs) and the President of the ECB may appoint one (1) member each to participate in the meetings of the Board of Directors as observers.⁶⁸

On an *ad hoc* basis, other persons, including representatives from international institutions or organisations, such as the IMF, may be invited by the Board of Directors to attend its meetings.⁶⁹ In addition, representatives of non-euro area Member States participating on an *ad hoc* basis alongside the ESM in a financial assistance operation for a euro area Member State must also be invited to participate, as observers, in the meetings of the Board of Directors, when this financial assistance and its subsequent monitoring is to be discussed.⁷⁰

Additional detailed provisions regarding the attendance at the meetings of the Board of Directors are included in Article 3 of its Rules of Procedure.

On the current composition of the Board of Directors, see below Table 3.

(d) The Board of Directors meetings are chaired by the Managing Director (on this body, *see* below, under 2.2.3).⁷¹ It must ensure that the ESM is run in accordance with the provisions laid down in its Treaty, as well as the ESM By-Laws adopted by the Board of Governors (*see* above, under 2.2.1.1(f)). To this end, it must take all the relevant Decisions as provided for in the ESM Treaty, including those which are delegated to it by the Board of Governors.⁷²

⁶⁴ **ESM Treaty**, Article 6, paragraph 1, first sentence. The first appointments by the Governors regarding their respective Directors and alternate Directors were made within two (2) months of the entry into force of the ESM Treaty (*Ibid.*, Article 43, paragraph 2).

⁶⁵ **ESM By-Laws**, Article 13, paragraph 1. While holding office at the ESM and for a period of six (6) months thereafter, a Director or alternate Director may not engage in such activities as may be determined from time to time by the Board of Governors, acting by qualified majority, pursuant to Articles 5 (paragraph 7, point (d)) and 6 (paragraph 8) of the **ESM Treaty** (*Ibid.*, Article 13, paragraph 2).

⁶⁶ **ESM Treaty**, Article 6, paragraph 1, third sentence.

⁶⁷ *Ibid.*, Article 6, paragraph 1, second sentence. Any vacancy in the Board of Directors must be immediately filled (*Ibid.*, Article 6, paragraph 7).

⁶⁸ *Ibid.*, Article 6, paragraph 2.

⁶⁹ *Ibid.*, Article 6, paragraph 4.

⁷⁰ *Ibid.*, Article 6, paragraph 3. Of relevant importance is also the content of Recital 9.

⁷¹ *Ibid.*, Article 7, paragraph 3.

⁷² *Ibid.*, Article 6, paragraph 6.

Detailed provisions regarding the meetings of the Board of Directors are included in Article 6 of the ESM By-Laws, as well as in Articles 2, 4, 5, 6, 7 and 10 of its Rules of Procedure.

(e) Finally, the Rules of Procedure of the Board of Directors, as well as the list of activities incompatible with the duties of a Director or an alternate Director, are laid down by the Board of Governors.⁷³

The Rules of Procedure of the Board of Directors were adopted on 8 October 2012, on the day the ESM was inaugurated. As of March 2015, they have not (yet) been amended.

2.2.2.2 Procedural provisions

(a) As specified in the ESM Treaty, the Decisions of the Board of Directors must be taken:

- by **mutual agreement** (i.e. ‘unanimity’),⁷⁴
- by **qualified majority** (requiring 80% of the votes cast),⁷⁵ or
- by **simple majority** (requiring the majority of the votes cast).⁷⁶

As a general principle and in respect of all Decisions, a quorum of 2/3 of the Members with voting rights representing (at least) 2/3 of the voting rights must be present, during its meetings.⁷⁷

*By way of derogation from the above-mentioned, an emergency voting procedure must be used whereas the European Commission and the ECB both conclude that a failure to urgently adopt a Decision to grant or implement financial assistance, as defined in Articles 13-18 of the ESM Treaty, would threaten the economic and financial sustainability of the euro area as a whole. If such a case prevails, the adoption of a Decision by mutual agreement by the Board of Directors, under that emergency procedure requires a **qualified majority of 85% of the votes cast**.*⁷⁸

Article 8 of the ESM By-Laws contains additional detailed provisions regarding this procedure.

(b) The voting rights of each Member, as exercised by its appointee or by the latter's representative on the Board of Directors, according to the above-mentioned (under 2.2.2.1(b)), must be equal to the number of shares allocated to it in the authorised capital stock of the ESM, as set out in the relevant Annex of the **ESM Treaty**.⁷⁹

⁷³ *Ibid.*, Article 6, paragraph 8.

⁷⁴ It is worth pointing out that the adoption of a Decision by mutual agreement requires the unanimity of the Members participating in the voting procedure. Abstentions do not prevent the adoption of a Decision by mutual agreement (*Ibid.*, Article 4, paragraph 3).

⁷⁵ *Ibid.*, Article 4, paragraph 5.

⁷⁶ *Ibid.*, Article 4, paragraph 6.

⁷⁷ *Ibid.*, Article 4, paragraph 2, second sentence.

⁷⁸ *Ibid.*, Article 4, paragraph 4, first sub-paragraph.

⁷⁹ *Ibid.*, Article 4, paragraph 7.

Detailed provisions regarding the voting procedure of the Board of Directors are included in Article 7 of the ESM By-Laws, as well as in Articles 8, 9 and 11 of its Rules of Procedure.

(c) In exceptional cases, if any ESM Member fails to pay (in whole or in part) the amount in respect of its obligations in relation to paid-in shares and/or calls of capital under the provisions laid down in **Articles 8, 9 and 10** of the **ESM Treaty**, or in relation to the reimbursement of the financial assistance under the provisions laid down in **Articles 16 or 17** therein, such Member must be unable, for the time period that such failure continues to apply, to exercise any of its voting rights.⁸⁰ Subsequently, the voting thresholds must be recalculated accordingly.⁸¹

(d) Nevertheless, and without prejudice to the above, the Decisions must be taken (as a general rule) by qualified majority, unless otherwise stated in the **ESM Treaty**.⁸² In addition, Decisions to be taken on the basis of powers delegated by the Board of Governors must be adopted in accordance with the relevant voting rules set in **Article 5, paragraphs 6 and 7** therein (*see* above, under 2.2.1.2(d)-(e) respectively).⁸³

⁸⁰ *Ibid.*, Article 4, paragraph 8, first sentence.

⁸¹ *Ibid.*, Article 4, paragraph 8, second sentence.

⁸² *Ibid.*, Article 6, paragraph 5, first sentence.

⁸³ *Ibid.*, Article 6, paragraph 5, second sentence.

TABLE 3

The composition of the ESM Board of Directors (as of March 2015)

| Member State | Director | Alternate Director |
|--------------|---------------------------------|------------------------------|
| Austria | Harald Waiglein | Paul Schieder |
| Belgium | Jozef Kortleven | Steven Costers |
| Cyprus | George Panteli | Marios Stephanides |
| Estonia | Märten Ross | Andrus Säälük |
| Finland | Tuomas Saarenheimo | Seppo Tanninen |
| France | Bruno Bézard | Muriel Lacoue-Labarthe |
| Germany | Thomas Steffen | Thomas Westphal |
| Greece | George Chouliarakis | Christos Antonopoulos |
| Ireland | Nicholas O'Brien | Maeve von Heynitz |
| Italy | Vincenzo La Via | Gelsomina Vigliotti |
| Latvia | Līga Klavina | Nils Sakss |
| Lithuania | Miglė Tuskienė | Gita Šematovičiūtė |
| Luxembourg | Isabelle Goubin | Raoul Wirtz |
| Malta | Alfred Camilleri | Ivan-Carl Saliba |
| Netherlands | Hans Vijlbrief | Focco Vijselaar |
| Portugal | Isabel Castelo Branco | Álvaro Matias |
| Slovakia | Vazil Hudák | Zuzana Nehajová |
| Slovenia | Irena Sodin | Alenka Jerkič |
| Spain | Rosa María Sánchez-Yebra Alonso | Carla Díaz Álvarez de Toledo |

The European Commissioner for Economic and Monetary Affairs (Pierre Moscovici) and the President of the ECB (Mario Draghi) may appoint one (1) member each to participate in the meetings of the Board of Directors as observers.

On an ad hoc basis, other persons, including representatives from international institutions or organisations, such as the IMF, may be invited by the Board of Directors to attend its meetings.

In addition, representatives of non-euro area Member States participating on an ad hoc basis alongside the ESM in a financial assistance operation for a euro area Member State must also be invited to participate, as observers, in the meetings of the Board of Directors, when this financial assistance and its subsequent monitoring is to be discussed.

The ESM Board of Directors is chaired by the Managing Director (Klaus Regling).

2.2.3 The Managing Director

2.2.3.1 Introductory remarks

(a) The Managing Director is appointed by the Board of Governors from among candidates, which fulfil the following criteria:

- possess the nationality of an ESM Member,
- have relevant international experience, and
- demonstrate a high level of competence in economic and financial matters.⁸⁴

Whilst holding office, the Managing Director is prohibited from possessing the status of:

- a Governor,
- a Director, and/or
- an alternate of either.⁸⁵

(b) The term of his/her office must be five (5) years,⁸⁶ renewable only once.⁸⁷ Nevertheless, he/she must cease to hold office when the Board of Governors so decides, following the adoption of a relevant Decision, taken by qualified majority (*see* above, under 2.2.1.2(e)).⁸⁸

On 8 October 2012, the Board of Governors, in accordance with the procedural provisions laid down in Article 43, paragraph 2 of the ESM Treaty, appointed (on a (renewable only once) term of five (5) years) the current CEO of the EFSF, Klaus Regling, as Managing Director of the ESM.

2.2.3.2 Duties

(a) As already mentioned above (under 2.2.2.1(d)), the Managing Director chairs the meetings of the Board of Directors. In addition, he/she must also participate, as an observer,⁸⁹ in the meetings of the Board of Governors.⁹⁰ In this capacity, he/she must sign the so-called ‘Financial Assistance Facility Agreement’, specifying the financial terms and conditions of the granted stability support towards an ESM Member, irrespective of the financial assistance instrument chosen.⁹¹

⁸⁴ *Ibid.*, Article 7, paragraph 1, first sentence.

⁸⁵ *Ibid.*, Article 7, paragraph 1, second sentence.

⁸⁶ *Ibid.*, Article 7, paragraph 2, first sentence.

⁸⁷ *Ibid.*, Article 7, paragraph 2, second sentence.

⁸⁸ *Ibid.*, Article 7, paragraph 2, third sentence.

⁸⁹ It is worth pointing out that the **ESM Treaty** does not refer explicitly to the legal status conferred upon the Managing Director regarding his participation in the meetings of the Board of Governors. On the contrary, this is explicitly referred to in Article 3, paragraph 1, point (b), (third indent), on the **Rules of Procedure** of the Board of Governors.

⁹⁰ **ESM Treaty**, Article 7, paragraph 3.

⁹¹ *Ibid.*, Articles 13 (paragraph 3, first sub-paragraph, third sentence), 14 (paragraph 3), 15 (paragraph 3), 16 (paragraph 3), 17 (paragraph 3) and 18 (paragraph 4).

(b) The Managing Director must be chief of staff of the ESM.⁹² In this capacity, he/she must be held responsible for:

- organising, appointing and dismissing staff, and
- managing the human resources of the ESM, while taking into consideration the staff rules adopted by the Board of Directors.⁹³

*The Decision regarding the staff rules adopted by qualified majority by the Board of Directors sets forth the terms and conditions of employment of the staff engaged by, or seconded to the ESM, as well as those of its Managing Director.*⁹⁴

In this regard, he/she may issue general administrative orders on such personnel matters as are identified by the adopted staff rules.⁹⁵

In addition, when recruiting and managing the human resources of the ESM, the Managing Director must pay due regard to:

- the transfer and the optimal integration and utilisation of the human resources and ‘know-how’ available at the EFSF with a view to ensuring efficiency and continuity, and
- the paramount importance of the personal ability, technical competence and qualifications of the relevant persons.⁹⁶

The recruiting, employment, classification, training, promotion and career development generally of members of staff of the ESM must be made without discriminating against any person, because of gender, race, ethnic or social origin, creed, sexual orientation or nationality.⁹⁷

(c) Finally, the Managing Director must be the legal representative of the ESM and must conduct, under the direction of the Board of Directors, the current business of the ESM.⁹⁸ In this capacity, and without prejudice to the provisions laid down in **Articles 13 (paragraph 3, first subparagraph, third sentence), 14 (paragraph 3), 15 (paragraph 3), 16 (paragraph 3), 17 (paragraph 3) and 18 (paragraph 4) of the ESM Treaty** (see above, under (a)), he/she must validly represent the ESM in dealings with third parties and in legal proceedings.⁹⁹

Nevertheless, in case of his/her absence the ESM must be validly represented in the above-mentioned cases by:

- any two (2) Directors acting jointly, and*
- any person acting within the limits of specific powers delegated by the Managing Director.*¹⁰⁰

⁹² **ESM Treaty**, Article 7, paragraph 4, first sentence and **ESM By-Laws**, Article 18, paragraph 3, first sub-paragraph, first sentence.

⁹³ **ESM Treaty**, Articles 7, paragraph 4, second sentence and **ESM By-Laws**, Article 18, paragraph 3, first sub-paragraph, second sentence.

⁹⁴ **ESM By-Laws**, Article 18, paragraph 1 and **ESM Treaty**, Article 33.

⁹⁵ **ESM By-Laws**, Article 18, paragraph 3, second sub-paragraph.

⁹⁶ *Ibid.*, Article 18, paragraph 4.

⁹⁷ *Ibid.*, Article 18, paragraph 5.

⁹⁸ **ESM Treaty**, Article 7, paragraph 5.

⁹⁹ **ESM By-Laws**, Article 16.

¹⁰⁰ *Ibid.*

2.2.4 Other dedicated staff

2.2.4.1 The Board of Auditors

2.2.4.1.1 Introductory remarks

(a) The preservation and maintenance of the proper functioning of the ESM as a whole, is conferred upon its Treaty to an *independent internal body*, the Board of Auditors.

(b) It consists of five (5) members appointed by the Board of Governors, acting by qualified majority, according to the above-mentioned (under 2.2.1.2(e)), for their competence in auditing and financial matters.¹⁰¹ These appointments must include:

- two (2) members upon the proposal of the Chairperson of the Board of Governors,
- two (2) members nominated by the national supreme audit institutions of two (2) of its Members,¹⁰² and
- one (1) Member nominated by the European Court of Auditors.¹⁰³

(c) As a general rule, its members must be appointed for a (non-renewable) term of three (3) years.¹⁰⁴ Exceptionally, among the first nominations, one (1) of the members proposed by the Chairperson of the Board of Governors, and one (1) of those nominated by the national supreme audit institutions of two (2) of the ESM Members, whose names are drawn by lot, must be appointed for a (non-renewable) term of four (4) years.¹⁰⁵

On the current composition of the Board of Auditors, see below Table 4.

(d) As a precondition for appointment to the Board of Auditors, nominees must possess the professional knowledge, skills and auditing experience that are necessary for the proper performance of the Board's tasks.¹⁰⁶

(e) It must elect a Chairperson and a Vice-Chairperson from among its members, each for a (renewable) term of one (1) year.¹⁰⁷

As of March 2015, Chairperson of the Board of Auditors is Ulrich Graf (nominee of the supreme audit institution of the Federal Republic of Germany) and Vice-Chairperson Igors Ludboržs (nominee of the European Court of Auditors).

(f) Finally, in accordance with international standards, its Members must take care to avoid all conflicts of interests and refrain from any action incompatible with their

¹⁰¹ **ESM Treaty**, Article 30, paragraph 1.

¹⁰² The first one is appointed from the group of half of the ESM Members (rounded down to the nearest integer number) holding the highest number of shares of the ESM, and the other from the group of the remaining Members, according to a rotation system following the English alphabetical order of the names of the ESM Members in each group, as stated in the relevant Annex of the ESM Treaty (**ESM By-Laws**, Article 24, paragraph 1, first sub-paragraph, second indent).

¹⁰³ **ESM By-Laws**, Article 24, paragraph 1, first sub-paragraph and **ESM Treaty**, Article 30, paragraph 1.

¹⁰⁴ **ESM By-Laws**, Article 24, paragraph 1, second sub-paragraph.

¹⁰⁵ *Ibid.*

¹⁰⁶ *Ibid.*, Article 24, paragraph 1, third sub-paragraph.

¹⁰⁷ *Ibid.*, Article 24, paragraph 2.

duties, at the time of their appointment and both during and after their term of office.¹⁰⁸ In the performance of their duties, they must neither seek, nor take instructions from:

- the ESM decision-making bodies (*see* above, under 2.2.1, 2.2.2 and 2.2.3),
- the ESM Members,
- any national government, and
- any other public or private body.¹⁰⁹

Thus, their independence must be beyond doubt.¹¹⁰

2.2.4.1.2 Duties

(a) The Board of Auditors must draw up independent audits.¹¹¹ For this purpose, it must be able to inspect the ESM accounts and verify that the operational accounts and balance sheets are in order.¹¹²

In addition, it must audit regularity, compliance, performance and risk management of the ESM, in accordance with international auditing standards,¹¹³ as well as monitor and review, on a regular basis, the ESM's internal and external¹¹⁴ audit processes and their respective results.¹¹⁵

Towards this end, it must have full access to any document and information of the ESM, including data of internal and external processes, needed for the implementation of its tasks.¹¹⁶

(b) It must draw up an annual report for the Board of Governors to report on its audit work, its audit findings in relation to the operational accounts and balance sheet, as well as its conclusions and recommendations.¹¹⁷ The Board of Directors may also be informed of its findings at any time.¹¹⁸

Subsequently and no later than thirty (30) days after having received the annual report from the Board of Auditors, the Board of Governors must make it accessible to:

- the national parliaments and supreme audit institutions of the ESM Members, and

¹⁰⁸ *Ibid.*, Article 24, paragraph 9, first sentence.

¹⁰⁹ **ESM By-Laws**, Article 24, paragraph 9, second sentence and **ESM Treaty**, Article 30, paragraph 2, second sentence.

¹¹⁰ **ESM By-Laws**, Article 24, paragraph 9, third sentence and **ESM Treaty**, Article 30, paragraph 2, first sentence.

¹¹¹ **ESM Treaty**, Article 30, paragraph 3, first sentence.

¹¹² *Ibid.*, Article 30, paragraph 3, second sentence.

¹¹³ *Ibid.*, Article 28.

¹¹⁴ The external audit processes are governed by the provisions laid down in Article 29 of the **ESM Treaty** and those in Article 22 of the **ESM By-Laws**.

¹¹⁵ **ESM By-Laws**, Article 24, paragraph 4, first sub-paragraph.

¹¹⁶ **ESM By-Laws**, Article 24, paragraph 4, second sub-paragraph and **ESM Treaty**, Article 30, paragraph 3, third sentence.

¹¹⁷ **ESM By-Laws**, Article 24, paragraph 6, first sub-paragraph and **ESM Treaty**, Article 30, paragraph 4, second sentence.

¹¹⁸ **ESM Treaty**, Article 30, paragraph 4, first sentence.

- the European Court of Auditors.¹¹⁹

The report must be simultaneously submitted to the European Parliament for information.¹²⁰

(c) Upon request of the Board of Governors and/or the Managing Director, the Board of Auditors may decide to draw up additional reports.¹²¹ Any such reports must be confidential and shall not be published or disclosed to third parties, unless the Board of Governors or the Managing Director permits otherwise.¹²²

*Before adopting any audit report, the Board of Auditors must give auditees and third parties a reasonable opportunity to comment on those points in such reports that refer to them by name or in a manner easily identifiable by the reader.*¹²³

2.2.4.1.3 Procedural provisions

(a) As a general rule, the Decisions must be taken by simple majority (i.e. majority of the votes cast).¹²⁴ During the meetings, (at least) three (3) of its Members must be present, in order for the Board to validly deliberate.¹²⁵

(b) In addition, its Members may participate in these meetings by means of:

- teleconferencing,
- any other electronic means allowing real-time bidirectional communication, and/or
- multidirectional communication, enabling participants to hear all other participants and address the meeting from a remote location.¹²⁶

For purposes of the quorum requirement, participation by such means constitutes presence in person.¹²⁷

(c) Finally, it must establish its relevant Rules of Procedure to govern its proceedings.¹²⁸

As of March 2015, its Rules of Procedure have not (yet) been established.

¹¹⁹ **ESM By-Laws**, Article 24, paragraph 6, second sub-paragraph, first sentence and **ESM Treaty**, Article 30, paragraph 5.

¹²⁰ **ESM By-Laws**, Article 24, paragraph 6, second sub-paragraph, second sentence.

¹²¹ *Ibid.*, Article 24, paragraph 7, first sentence.

¹²² *Ibid.*, Article 24, paragraph 7, second sentence.

¹²³ *Ibid.*, Article 24, paragraph 8.

¹²⁴ *Ibid.*, Article 24, paragraph 3, first sub-paragraph, second sentence.

¹²⁵ *Ibid.*, Article 24, paragraph 3, first sub-paragraph, first sentence.

¹²⁶ *Ibid.*, Article 24, paragraph 3, second sub-paragraph, first sentence.

¹²⁷ *Ibid.*, Article 24, paragraph 3, second sub-paragraph, second sentence.

¹²⁸ *Ibid.*, Article 24, paragraph 3, third sub-paragraph.

| TABLE 4 | | |
|---|------------------|--|
| The composition of the ESM Board of Auditors (as of March 2015) | | |
| Name | Status | Nominated by |
| Ulrich Graf | Chairperson | Supreme Audit Institution of the Federal Republic of Germany |
| Igors Ludboržs | Vice-Chairperson | European Court of Auditors |
| Marc Gengler | Member | Supreme Audit Institution of the Grand Duchy of Luxembourg |
| Jules Muis | Member | Proposal of the Chairperson of the Board of Governors |
| Katarína Kaszasová | Member | Proposal of the Chairperson of the Board of Governors |

2.2.4.2 The Management Board

(a) The Management Board consists of the Managing Director, who chairs the Board, and such other members of the ESM's staff as the Managing Director designates from time to time.¹²⁹

On the current composition of the Management Board, see below **Table 5**.

(b) Its main duties are:

- to assist the Managing Director in conducting the current business of the ESM,
- to prepare the Decisions of the Board of Governors and the Board of Directors, and
- to monitor their implementation.¹³⁰

(c) Nevertheless, it must neither be a decision-making body of the ESM for matters going beyond the ESM's internal affairs, nor have any power of external representation of the ESM.¹³¹

| TABLE 5 | |
|--|----------------------------------|
| The composition of the ESM Management Board (as of March 2015) | |
| Name | Capacity |
| Klaus Regling | Managing Director |
| Christophe Frankel | Deputy Managing Director and CFO |
| Kalin Anev Janse | Secretary General |
| Ralf Jansen | General Counsel |
| Rolf Strauch | Economics and Policy Strategy |

¹²⁹ *Ibid.*, Article 11, paragraph 1.

¹³⁰ *Ibid.*, Article 11, paragraph 2.

¹³¹ *Ibid.*, Article 11, paragraph 3.

2.2.4.3 The Secretary

(a) The Secretary General of the ESM must serve as secretary of the Board of Governors and the Board of Directors. In exceptional cases, in his/her absence, a member of the staff of the ESM, designated by him/her must act in this capacity, during the meetings of the above-mentioned decision-making bodies.¹³²

As of March 2015, Kalin Anev Janse is the Secretary General of the ESM. He is also the Secretary General of the EFSF, a position he has held since 2011.

(b) He/she must prepare minutes and a summary record of the proceedings of the meetings of the Board of Governors and the Board of Directors.¹³³ More specifically, these minutes must contain:

- (i) the names of the persons present and represented,
- (ii) the agenda items,
- (iii) the Decisions adopted, and
- (iv) such other matters as may be specified in the relevant Rules of Procedure of the decision-making bodies mentioned above, as the case may be.¹³⁴

(c) The draft minutes, as well as the summary record of proceedings must be presented for approval at the next meeting of the Board of Governors and/or the Board of Directors, as the case may be, or, where necessary, by written procedure pursuant to **Articles 4 or 7** of the **ESM By-Laws**.¹³⁵

Subsequently, these must be signed:

- by the Chairperson (regarding the meetings of the Board of Governors),
- by the Managing Director (regarding the meetings of the Board of Directors),
or
- in exceptional cases, by the Secretary General and the person responsible for the legal affairs of the ESM.¹³⁶

¹³² *Ibid.*, Article 9.

¹³³ *Ibid.*, Article 10, paragraph 1, first sub-paragraph.

¹³⁴ *Ibid.*, Article 10, paragraph 2.

¹³⁵ *Ibid.*, Article 10, paragraph 1, second sub-paragraph.

¹³⁶ *Ibid.*, Article 10, paragraph 1, third sub-paragraph.

3. Other aspects

3.1 Professional secrecy

(a) According to **Article 34** of the **ESM Treaty**, the Members of the Board of Governors and of the Board of Directors, as well as any other persons who work for the ESM, shall not disclose any information that is subject to professional secrecy.

(b) In addition, they shall be required not to disclose any information of the kind covered by the obligation of professional secrecy, even after their duties have ceased. This applies also for the (former) Members of the above-mentioned decision-making bodies, as well as any other persons who have worked for the ESM.

(c) Towards this end, the Board of Directors, acting by qualified majority (*see* above, under 2.2.2.2(d)), must adopt a code of conduct, setting forth the obligations on matters, such as:

- confidentiality,
- public statements and contacts with the media,
- personal investments, and
- disclosure of financial and business interests.

It must be binding in its entirety on the Managing Director and all the Directors, alternate Directors, as well as the members of staff of the ESM.¹³⁷

*This Code of Conduct was adopted, in accordance with the above-mentioned procedure, by the Board of Directors on 12 March 2014. It should be noted, however, that it does not include provisions regarding the disclosure of documents to third persons and/or entities. This is governed by certain provisions laid down in **Article 17** of the **ESM By-Laws**.*

3.2 Immunities of persons

(a) As a general rule and taking into account the interest of the ESM, certain persons must be immune from legal proceedings with respect to acts performed by them in their official capacity. Thus, they must enjoy inviolability in respect of their official papers and documents.¹³⁸ In particular, these apply for:

- the Chairperson of the Board of Governors,
- the Governors,
- the alternate Governors,
- the Directors,
- the alternate Directors,
- the Managing Director, and
- other staff members, according to the above (under 2.2.4).¹³⁹

¹³⁷ *Ibid.*, Article 19.

¹³⁸ **ESM Treaty**, Article 35, paragraph 1.

¹³⁹ *Ibid.*

(b) Nevertheless, the Board of Governors may waive to such extent and upon such conditions as it determines any of the immunities in respect of:

- its Chairperson,
- a Governor,
- an alternate Governor,
- a Director,
- an alternate Director, and/or
- the Managing Director.¹⁴⁰

In addition, the Managing Director holds the privilege to waive any such immunity in respect of any member of staff of the ESM, other than himself/herself.¹⁴¹

(c) Finally, each ESM Member must promptly take all the actions necessary for the purposes of giving effect to the above-mentioned, in terms of the provisions laid down in its relevant law.¹⁴² It must inform the ESM accordingly.¹⁴³

3.3 Exemption from taxation

(a) As a general rule, the ESM must, within the scope of its official activities, be exempt from all direct taxes.¹⁴⁴ In particular, this applies for:

- the assets,
- the income,
- the property, and
- the operations and transactions authorised by its Treaty.¹⁴⁵

In addition, no taxation of any kind must be levied on any obligation and/or securities issued by the ESM, including any interest or dividend thereon by whomsoever held:

(i) which discriminates against such obligation or security solely because of its origin, and

(ii) if the sole jurisdictional basis for such taxation is the place or currency in which it is issued, made payable or paid, or the location of any office or place of business maintained by the ESM.¹⁴⁶

This stands for all goods imported by the ESM, which are considered necessary for the exercise of its official activities, as well.¹⁴⁷

(b) Nevertheless, no exemption must be granted in respect of taxes and dues which amount merely to charges for public utility services.¹⁴⁸

¹⁴⁰ *Ibid.*, Article 35, paragraph 2.

¹⁴¹ *Ibid.*, Article 35, paragraph 3.

¹⁴² *Ibid.*, Article 35, paragraph 4.

¹⁴³ *Ibid.*

¹⁴⁴ *Ibid.*, Article 36, paragraph 1.

¹⁴⁵ *Ibid.*

¹⁴⁶ *Ibid.*, Article 36, paragraph 6.

¹⁴⁷ *Ibid.*, Article 36, paragraph 4.

(c) As far as the dedicated staff of the ESM is concerned, it must (for the benefit of the ESM as a whole) be subject to an internal tax on their paid salaries and emoluments, the arrangement of which is left to the rules adopted by the Board of Governors (*see* above, under 2.2.1.2(e)).¹⁴⁹ Subsequently, from the date on which this tax is applied, such salaries and emoluments shall be exempt from the application of any national income tax.¹⁵⁰

(d) Finally, the ESM Members must (wherever possible) take the appropriate measures:

- to remit the amount of indirect taxes-sales taxes included in the price of movable or immovable property where the ESM makes, for its official use, substantial purchases, the price of which includes taxes of this kind, and/or
- to refund the amount of indirect taxes-sales taxes included in the price of movable or immovable property where the ESM makes, for its official use, substantial purchases, the price of which includes taxes of this kind.¹⁵¹

3.4 Interpretation and dispute settlement

(a) In principle, any questions of interpretation or application of the provisions of the ESM Treaty, as well as the By-Laws of the ESM must be duly submitted to the Board of Directors, for the *latter* to decide accordingly.¹⁵²

These questions on matters of interpretation or application of the provisions of the above-mentioned legal texts may arise between:

- the ESM and any of its Members, or
- (solely) the ESM Members.¹⁵³

(b) In addition, the Board of Governors must be held liable to decide (as mentioned above, under 2.2.1.2(e)) on any dispute, in connection with the interpretation and application of the ESM Treaty, including those related to the compatibility of the Decisions adopted by the ESM decision-making bodies therein.¹⁵⁴

Again, these disputes may arise between:

- the ESM and any of its Members, or
- (solely) the ESM Members.¹⁵⁵

The votes of the member(s) of the Board of Governors of the ESM Member(s) concerned must be suspended, when the Board of Governors votes on such Decision.¹⁵⁶

¹⁴⁸ *Ibid.*, Article 36, paragraph 3.

¹⁴⁹ *Ibid.*, Article 36, paragraph 5, first sentence.

¹⁵⁰ *Ibid.*, Article 36, paragraph 5, second sentence.

¹⁵¹ *Ibid.*, Article 36, paragraph 2.

¹⁵² *Ibid.*, Article 37, paragraph 1. The provisions of this Article are further analysed in **Stratigopoulou and Mylonakis (2013)**, pp. 25-26.

¹⁵³ **ESM Treaty**, Article 37, paragraph 1.

¹⁵⁴ *Ibid.*, Article 37, paragraph 2, first sentence.

¹⁵⁵ *Ibid.*

¹⁵⁶ *Ibid.*, Article 37, paragraph 2, second sentence.

Subsequently, the voting threshold needed for the adoption of that particular Decision must be recalculated accordingly.¹⁵⁷

(c) In exceptional cases, if an ESM Member contests the Decision taken, according to the above (under (b)), the dispute must be consigned to the Court of Justice of the European Union (hereinafter the ‘EU’).¹⁵⁸ **Recital 16 of the ESM Treaty** is firm on this:

‘Disputes concerning the interpretation and application of this Treaty arising between the Contracting Parties or between the Contracting Parties and the ESM should be submitted to the jurisdiction of the Court of Justice of the EU, in accordance with Article 273 TFEU.’

Article 273 TFEU states in this respect:

‘The Court of Justice shall have jurisdiction in any dispute between Member States which relates to the subject matter of the Treaties if the dispute is submitted to it under a special agreement between the parties.’¹⁵⁹

The judgment of the Court of Justice of the EU must be binding on the parties in the procedure, which must take the necessary measures to comply with the judgment within a fixed period decided by said Court.¹⁶⁰

(d) Finally, an independent body that hears and passes judgment on staff employment matters within its competence, called the ‘Administrative Tribunal’, was established, following the adoption, through a proper Decision, of its Statute by the Board of Directors on 29 October 2013. This Tribunal is composed of five (5) members, including a President and a Vice-President.

On the current composition of the Administrative Tribunal, see below Table 6.

On 4 December 2014, it established, pursuant to Article 5, paragraph 1 of its Statute, its Rules of Procedure.

| TABLE 6 | |
|--|-----------------|
| The composition of the ESM Administrative Tribunal (as of March 2015) | |
| Name | Capacity |
| Virginia Melgar | President |
| Haris Tagaras | Vice-President |
| Julian Currall | Member |
| Celia Goldman | Member |
| Gerhard Ullrich | Member |

¹⁵⁷ *Ibid.*

¹⁵⁸ *Ibid.*, Article 37, paragraph 3, first sentence.

¹⁵⁹ OJ C 326, 26.10.2012, p. 165.

¹⁶⁰ **ESM Treaty**, Article 37, paragraph 3, second sentence.

3.5 International cooperation

(a) According to **Article 38** of the **ESM Treaty**, and in order to further its purpose, as mentioned above (under 1(c)), the ESM is entitled to cooperate with the IMF¹⁶¹. **Recital 8** of the **ESM Treaty** states in this respect:

'The ESM will cooperate very closely with the IMF in providing stability support. The active participation of the IMF will be sought, both at technical and financial level. A euro area Member State requesting financial assistance from the ESM is expected to address, wherever possible, a similar request to the IMF.'

With regard to the cooperation regime between the ESM and the IMF, the author fully subscribes to the comment made in **Lastra and Louis (2013)**, pp. 142-143:

'The IMF is now firmly inserted in the life of the EU. But there is no specific framework agreement (...) on the intervention in assistance processes, despite the intensive existing collaboration. This probably reflects the past hesitation in some quarters within the EU/euro area on too close an involvement of the Washington institution in European affairs. It is perhaps also a sign of the preoccupation of the Bretton Woods¹⁶² institutions to appear to be devoting too much of their resources and activity to Europe. It is not to be excluded that the pressure for a balance more favourable to developing and emerging countries, not only in the allocation of quotas and votes but also in the appointment of the managing director, is partly due to the important involvement of the IMF in European affairs since the end of the nineties.'

(b) Furthermore, it is also entitled to cooperate with:

(i) any State which provides financial assistance to an ESM Member on an *ad hoc* basis, and

(ii) any international organisation or entity having specialised responsibilities in related fields.

In the author's opinion, this particular provision has already been used as a legal basis thrice, in order to establish partnership frameworks in the following cases (besides the already established close cooperation with the IMF):

- (a) upon signing a relevant Memorandum of Understanding ('MoU') with the European Bank for Reconstruction and Development (the 'EBRD'),¹⁶³
- (b) upon signing a relevant Memorandum of Understanding ('MoU') with the Nordic Investment Bank (the 'NIB'),¹⁶⁴ and
- (c) upon signing a relevant Memorandum of Understanding ('MoU') with the Council of Europe Development Bank (the 'CEB').¹⁶⁵

¹⁶¹ For a general overview of the role of the IMF within the international monetary system, see indicatively **Lowenfeld (2008)**, pp. 628-666.

¹⁶² On the key elements of the so-called 'Bretton Woods' international monetary system, see indicatively **Bordo (1993)**, pp. 3-108, **Lowenfeld (2008)**, pp. 597-627 and **Hieronimi (2013)**, pp. 24-26.

¹⁶³ See on this at: <http://www.esm.europa.eu/press/releases/ebrd-and-esm-sign-memorandum-of-understanding.htm>

¹⁶⁴ See on this at: <http://www.esm.europa.eu/press/releases/esm-and-nib-sign-memorandum-of-understanding.htm>

¹⁶⁵ See on this at: <http://www.esm.europa.eu/press/releases/ceb-and-esm-sign-memorandum-of-understanding.htm>

All the above-mentioned ‘MoUs’ introduce a common framework between the ESM and those international institutions, which cover, inter alia, the following fields:

- technical assistance in areas of relevance to their respective financial and operational activities,
- collaboration through informal consultation and reciprocal sharing of information about their planned activities,
- relevant policies and programmes in order to exchange existing best practices,
- cooperation in research and policy advice activities, and
- staff exchanges through secondment.

However, they do not constitute a commitment to provide financial support to each other.

3.6 Transitional arrangements¹⁶⁶

3.6.1 Relation with EFSF lending

(a) During the transitional phase spanning the period upon the entry into force of the ESM Treaty until the complete run-down of the EFSF, the consolidated ESM and EFSF lending must not exceed the cumulative amount of 500 billion euros.¹⁶⁷ This is without prejudice to the regular review of the adequacy of the maximum lending capacity, in accordance with the above-mentioned (under 1(e)).¹⁶⁸

*For a comparative overview between the EFSF and the ESM, see below **Table 7**.*

(b) The Board of Directors must adopt detailed guidelines on the calculation of the so-called ‘Forward Commitment Capacity’,¹⁶⁹ in order to ensure that the consolidated lending ceiling is not breached.¹⁷⁰

The above-mentioned detailed guideline was adopted by the Board of Directors on 8 December 2014. As of March 2015, the ESM’s Forward Commitment Capacity amounts to 452.811 billion euros.

3.6.2 Transfer of EFSF supports

(a) By way of derogation from the provisions laid down in **Article 13** of the **ESM Treaty**, the Board of Governors may decide that the EFSF commitments to provide financial assistance to an ESM Member under its agreement with that member must be

¹⁶⁶ See on this **European Stability Mechanism (2012)**, p. 15.

¹⁶⁷ **ESM Treaty**, Article 39, first sentence. However, the combined ESM-EFSF maximum lending capacity was increased to 700 billion euros through the Board of Governors **Resolution No 11**, adopted in the meeting held on 8 October 2012, referring to the Eurogroup Statement on 30 March 2012. On this particular Statement, see above, under 1(e).

¹⁶⁸ **ESM Treaty**, Article 39, first sentence.

¹⁶⁹ According to Article 2 of the **Guideline on the Calculation of the Forward Commitment Capacity**, the term ‘Forward Commitment Capacity’ means: ‘the total amount of resources the ESM can commit during a twelve (12) month time horizon for financial assistance instruments, other than the Direct Recapitalisation Instrument (the ‘DRI’)’.

¹⁷⁰ **ESM Treaty**, Article 39, second sentence.

assumed by the ESM, as far as such commitments relate to undisbursed and unfunded parts of loan facilities.¹⁷¹

(b) Subsequently, the ESM may, if authorised by its Board of Governors, acquire the rights and assume the obligations of the EFSF, and in particular:

- all of its outstanding rights and obligations under, and related to, its existing loan facilities, or
- part of its outstanding rights and obligations under, and related to, its existing loan facilities.¹⁷²

(c) The Board of Governors must adopt the detailed modalities necessary to give effect to the transfer of the obligations from the EFSF to the ESM, in accordance with the above-mentioned (under 2.2.1.2(d)).¹⁷³

As of March 2015, these provisions have been used once, in particular in the case of the recapitalisation of the Spanish banking sector.

¹⁷¹ *Ibid.*, Article 40, paragraph 1.

¹⁷² *Ibid.*, Article 40, paragraph 2.

¹⁷³ *Ibid.*, Article 40, paragraph 3.

| TABLE 7 | | |
|--|---|---|
| Comparative overview between the EFSF and the ESM | | |
| Topics | EFSF | ESM |
| Legal Structure | Private Company under Luxembourg Law | Intergovernmental Financial Institution under (public) International Law |
| Legal Basis | Framework-Agreement | Article 136, paragraph 3 TFEU |
| Duration | Temporary (June 2010-June 2013) | Permanent Institution |
| Recipients | Euro area Member States | Euro area Member States |
| Capital Structure | Backed by Guarantees of euro area Member States | Subscribed Capital of 701,9 billion euros divided in: <ul style="list-style-type: none"> • Paid-in Shares (80,2 billion euros), and • Committed Callable Guarantees (621,7 billion euros) |
| Lending Capacity | 192 billion euros committed for Ireland, Portugal and Greece | 500 billion euros |
| Decision-making Bodies | CEO, Board of Directors and other dedicated staff | Board of Governors, Board of Directors, Managing Director and other dedicated staff |
| Financial Assistance Instruments | Precautionary financial assistance, Indirect recapitalisation of credit institutions (through loans to national governments), Loans, Primary market support facility, Secondary market support facility | Precautionary financial assistance, Indirect recapitalisation of credit institutions (through loans to national governments), Loans, Primary market support facility, Secondary market support facility, Direct recapitalisation of credit institutions |
| Creditor Status | Pari Passu | Preferred Creditor Status ¹⁷⁴ (after IMF) |

¹⁷⁴ Recital 13 of the **ESM Treaty** states in this respect (second and third sentences): ‘(...) *Heads of State or Government have stated that the ESM loans will enjoy preferred creditor status in a similar fashion to those of the IMF, while accepting preferred creditor status of the IMF over the ESM. This status will be effective as of the date of entry into force of this Treaty. In the event of ESM financial assistance in the form of ESM loans following a European financial assistance programme existing at the time of the signature of this Treaty, the ESM will enjoy the same seniority as all other loans and obligations of the beneficiary ESM Member, with the exception of the IMF loans*’.

On the IMF’s preferred creditor status, *see* indicatively **European Central Bank (2011a)**, pp. 79-80.

B. The DRI within the context of the European Banking Union

1. Introductory remarks

(a) As already mentioned above (under A, 1(c)), the ESM may provide stability support to its members, if indispensable to safeguard the financial stability of the euro area as a whole and of its Member States.¹⁷⁵ This stability support may be granted through the following six (6) financial instruments:¹⁷⁶

- a precautionary conditioned credit line (the ‘PCCL’) or an enhanced conditions credit line (the ‘ECCL’), under a ‘precautionary financial assistance programme’,¹⁷⁷
- loans earmarked for the specific purpose of recapitalising the financial institutions of its members, under a ‘financial assistance recapitalisation facility’ (also known as the ‘Indirect Recapitalisation Instrument’),¹⁷⁸
- loans, under a ‘macroeconomic adjustment programme’,¹⁷⁹
- purchase of bonds of its members on the primary market, under a ‘primary market¹⁸⁰ support facility’,¹⁸¹

¹⁷⁵ **ESM Treaty**, Article 12, paragraph 1, first sentence.

¹⁷⁶ *Ibid.*, Article 12, paragraph 2.

¹⁷⁷ *Ibid.*, Article 14, paragraph 1.

The objective of this particular instrument is to support sound policies and prevent crisis situations from emerging. Therefore, it aims to assist the ESM Members whose economic conditions are still sound to maintain continuous access to market financing by strengthening the credibility of their macroeconomic performance, while ensuring an adequate safety net.

Detailed provisions on the modalities for implementing this form of financial assistance are included in the relevant guideline adopted by the Board of Directors (*Ibid.*, Article 14, paragraph 4).

For more details, see **European Stability Mechanism (2013)**, p. 47.

¹⁷⁸ **ESM Treaty**, Article 15, paragraph 1.

The objective of this particular instrument is to preserve the financial stability of the euro area by addressing cases in which the roots of a crisis are primarily in the financial sector and not directly related to fiscal or structural policies. Therefore, loans limit the contagion of financial stress by ensuring that a national government has the capacity to finance recapitalisation at sustainable borrowing costs and repair the financial sector to eliminate vulnerabilities.

Detailed provisions on the modalities for implementing this form of financial assistance are included in the relevant guideline adopted by the Board of Directors (*Ibid.*, Article 15, paragraph 4).

For more details, see **European Stability Mechanism (2013)**, p. 47.

¹⁷⁹ **ESM Treaty**, Article 16, paragraph 1.

The objective of this particular instrument is to assist the ESM Members in significant need of financing, but which have lost access to the markets, either because they cannot find lenders or because lenders will provide financing only at excessive prices that would adversely impact the sustainability of public finances.

Detailed provisions on the modalities for implementing this form of financial assistance are included in the relevant guideline adopted by the Board of Directors (*Ibid.*, Article 16, paragraph 4).

For more details, see **European Stability Mechanism (2013)**, p. 46.

- purchase of bonds of its members on the secondary market, under a ‘secondary market¹⁸² support facility’,¹⁸³ and
- (as of 8 December 2014) *direct* investment in equity of ailing financial institutions, incorporated into its members (also known as the ‘*Direct Recapitalisation Instrument*’, hereinafter the ‘DRI’).

The examination of the DRI is the main subject of this working paper.

(b) As a general rule, the stability support provided by the ESM is subject to strict economic policy conditionality, appropriate to the financial assistance instrument chosen.¹⁸⁴ According to the above-mentioned (under A, 1(c)), such conditionality may range from a macro-economic adjustment programme to continuous respect of pre-established eligibility conditions.¹⁸⁵

(c) The details on the conditionality attached to the ‘financial assistance facility agreement’, are included in a relevant Memorandum of Understanding (hereinafter the ‘MoU’), the content of which must:

- reflect the severity of the weaknesses to be addressed and the financial assistance instrument chosen,¹⁸⁶ as well as

¹⁸⁰ A ‘primary market’ is a financial market to which certain classes of negative savers can turn in order to draw either borrowed and/or own funds from positive savers through the issuance of debt instruments and equities, respectively. For more details on this, as well as the distinction between the positive and negative savers, see **Gortsos (2012a)**, pp. 34 and 31, respectively.

¹⁸¹ **ESM Treaty**, Article 17, paragraph 1.

The objective if this particular instrument is to support the sound functioning of the national government debt markets of the ESM Members in exceptional circumstances where the lack of market liquidity threatens financial stability. Therefore, such intervention is designed to enable market-making that would ensure debt market liquidity and incentivise investors to further participate in the financing of their economies.

Detailed provisions on the modalities for implementing this form of financial assistance are included in the relevant guideline adopted by the Board of Directors (*Ibid.*, Article 17, paragraph 4).

For more details, see **European Stability Mechanism (2013)**, p. 46.

¹⁸² A ‘secondary market’ is a financial market where debt instruments and equities issued by negative savers are traded. See on this **Gortsos (2012a)**, p. 34.

¹⁸³ **ESM Treaty**, Article 18, paragraph 1.

The objective of this particular instrument is to support the sound functioning of the national government debt markets of the ESM Members in exceptional circumstances where the lack of market liquidity threatens financial stability. Therefore, such intervention is designed to enable market-making that would ensure debt market liquidity and incentivise investors to further participate in the financing of their economies.

Detailed provisions on the modalities for implementing this form of financial assistance are included in the relevant guideline adopted by the Board of Directors (*Ibid.*, Article 18, paragraph 5).

For more details, see **European Stability Mechanism (2013)**, p. 46.

¹⁸⁴ **ESM Treaty**, Article 12, paragraph 1, first sentence.

¹⁸⁵ *Ibid.*, Article 12, paragraph 1, second sentence.

¹⁸⁶ *Ibid.*, Article 13, paragraph 3, first sub-paragraph, first and second sentences.

- be fully consistent with the measures of economic policy coordination provided for in the provisions laid down in **Article 121 TFEU**¹⁸⁷, in particular with any act of the relevant EU law, including any opinion, warning, recommendation or Decision addressed to the ESM Member concerned.¹⁸⁸

Article 121 TFEU states in this respect (paragraphs 1-6):

(1) Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council, in accordance with the provisions of Article 120 TFEU.

(2) The Council shall, on a recommendation from the European Commission, formulate a draft for the broad guidelines of the economic policies of the Member States and of the Union, and shall report its findings to the European Council.

The European Council shall, acting on the basis of the report from the Council, discuss a conclusion on the broad guidelines of the economic policies of the Member States and of the Union.

On the basis of this conclusion, the Council shall adopt a recommendation setting out these broad guidelines. The Council shall inform the European Parliament of its recommendation.

(3) In order to ensure closer coordination of economic policies and sustained convergence of the economic performances of the Member States, the Council shall, on the basis of reports submitted by the European Commission, monitor economic developments in each of the Member States and in the Union as well as the consistency of economic policies with the broad guidelines referred to in paragraph 2, and regularly carry out an overall assessment.

¹⁸⁷ In the author's opinion, the economic policy coordination, as described in the relevant provisions laid down in Article 121 TFEU (ex Article 99 of the Treaty establishing the European Community, hereinafter the 'TEC') (OJ C 325, 24.12.2002, pp. 33-184) is one of the two (2) pillars of the (yet incomplete) European Economic Union. It is further analysed by **Council Regulation (EC) No 1466/1997** of 7 July 1997 'on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies' (OJ L 209, 2.8.1997, pp. 1-5), as in force. It has been amended twice by **Council Regulation (EC) No 1055/2005** of 27 June 2005 (OJ L 174, 7.7.2005, pp. 1-4) and **Regulation (EU) No 1175/2011** of the European Parliament and of the Council of 16 November 2011 (OJ L 306, 23.11.2011, pp. 12-24).

The second pillar of the (yet incomplete) European Economic Union is the one concerning budgetary discipline and excessive deficits, as described in the relevant provisions laid down in Article 123-126 TFEU (ex Articles 101-104 TEC respectively). In particular, the provisions of Article 126 TFEU are analysed by **Council Regulation (EC) No 1467/1997** of 7 July 1997 'on speeding up and clarifying the implementation of the excessive deficit procedure' (OJ L 209, 2.8.1997, pp. 6-11), as in force. It has been amended twice by **Council Regulation (EC) No 1056/2005** of 27 June 2005 (OJ L 174, 7.7.2005, pp. 5-9) and **Council Regulation (EU) No 1177/2011** of 8 November 2011 (OJ L 306, 23.11.2011, pp. 33-40). Both Regulations further specifying the provisions laid down in Articles 121 and 126 TFEU, alongside with a **European Council Resolution** of 17 June 1997 (OJ C 236, 2.8.1997, pp. 1-2), constitute the so-called 'Stability and Growth Pact' (the 'SGP').

It is worth pointing out that amidst the current fiscal crisis in the euro area, which became manifest in 2010, several legal acts have been adopted for the strengthening of the European Economic Union. For more details, see indicatively **European Central Bank (2011c)**, pp. 99-119, **European Central Bank (2012)**, pp. 79-94, **European Central Bank (2013)**, pp. 53-55, **Fabbrini (2013)**, pp. 1-38, **Lastra (2013)**, pp. 35-71, **Stephanou (2013)**, pp. 143-151 and **Alcidi, Giovannini and Piedrafita (2014)**, pp. 19-40.

¹⁸⁸ **ESM Treaty**, Article 13, paragraph 3, second sub-paragraph.

For the purpose of this multilateral surveillance, Member States shall forward information to the European Commission about important measures taken by them in the field of their economic policy and such other information as they deem necessary.

(4) Where it is established, under the procedure referred to in paragraph 3, that the economic policies of a Member State are not consistent with the broad guidelines referred to in paragraph 2 or that they risk jeopardising the proper functioning of the EMU, the European Commission may address a warning to the Member State concerned. The Council, on a recommendation from the European Commission, may address the necessary recommendations to the Member State concerned. The Council may, on a proposal from the European Commission, decide to make its recommendations public.

Within the scope of this paragraph, the Council shall act without taking into account the vote of the member of the Council representing the Member State concerned.

A qualified majority of the other members of the Council shall be defined, in accordance with Article 238, paragraph 3, point (a) TFEU.

(5) The President of the Council and the European Commission shall report to the European Parliament on the results of multilateral surveillance. The President of the Council may be invited to appear before the competent committee of the European Parliament, if the Council has made its recommendations public.

(6) The European Parliament and the Council, acting by means of regulations, in accordance with the ordinary legislative procedure, may adopt detailed rules for the multilateral surveillance procedure referred to in paragraphs 3 and 4.

Subsequently, the European Commission is entrusted with the signing of the relevant MoU on behalf of the ESM, subject to the formal approval by the Board of Governors (on this decision-making body, *see* above, under A, 2.2.1).¹⁸⁹ However, no financial assistance can be granted by the ESM, unless the following procedure takes place:

(i) An ESM Member may address a request for stability support to the Chairperson of the Board of Governors, indicating the financial assistance instrument(s) to be considered.¹⁹⁰

(ii) Upon receipt of such a request, the Chairperson of the Board of Governors must entrust the European Commission, in liaison with the ECB, with the following tasks:

- to assess the existence of a risk to the financial stability of the euro area as a whole or of its Member States, unless the ECB has already submitted an analysis pursuant to **Article 18, paragraph 2** of the **ESM Treaty**,
- to assess (wherever appropriate and possible) together with the IMF the sustainability of the public debt of the ESM Member concerned, and
- to assess its actual or potential financing needs.¹⁹¹

On the basis of the request by the ESM Member and the conduct of the above-mentioned comprehensive assessment, the Board of Governors may decide to grant, in

¹⁸⁹ *Ibid.*, Article 13, paragraph 4. The rationale behind the participation of the European Commission, in liaison with the ECB, is specified in Recital 10 therein, with further reference to the European Council meeting on 20 June 2011. The conclusions of this meeting are available at: <http://data.consilium.europa.eu/doc/document/ST-23-2011-REV-1/en/pdf>

¹⁹⁰ **ESM Treaty**, Article 13, paragraph 1, first sentence.

¹⁹¹ *Ibid.*, Article 13, paragraph 1, second sentence.

principle, stability support to the ESM Member concerned in the form of a ‘Financial Assistance Facility’.¹⁹²

(d) If a Decision pursuant to **Article 13, paragraph 2** of the **ESM Treaty** is adopted, the Board of Governors must entrust the European Commission, in liaison with the ECB and, (wherever possible), the IMF, with the task of negotiating, with the ESM Member concerned, an MoU, detailing the conditionality attached to the ‘Financial Facility Agreement’.¹⁹³

In parallel, the Managing Director of the ESM (*see* above, under A, 2.2.3) must prepare a proposal for a ‘Financial Assistance Facility Agreement’, including the financial terms and conditions and the choice of instruments, to be adopted by the Board of Governors.¹⁹⁴ In addition, the Board of Directors must approve:

- the ‘Financial Assistance Facility Agreement’, detailing the financial aspects of the stability support to be granted, and
- the disbursement of the first tranche of the assistance, where applicable.¹⁹⁵

(e) Finally, the competence to monitor compliance with the conditionality attached to the ‘Financial Assistance Facility Agreement’, is entrusted to the European Commission, in liaison with the ECB and, (wherever possible), together with the IMF.¹⁹⁶

¹⁹² *Ibid.*, Article 13, paragraph 2.

¹⁹³ *Ibid.*, Article 13, paragraph 3, first sub-paragraph, first sentence.

¹⁹⁴ *Ibid.*, Article 13, paragraph 3, first sub-paragraph, third sentence.

¹⁹⁵ *Ibid.*, Article 13, paragraph 5.

¹⁹⁶ *Ibid.*, Article 13, paragraph 7. The European Commission, in liaison with the ECB and the IMF, constitute the so-called ‘Troika’. *See* on this **Sapir, Wolff, Sousa and Terzi (2014)**.

2. The political agenda

2.1 The Decisions of June 2012 and of September 2012

(a) The prospect of *direct* recapitalisation of credit institutions incorporated in euro area Member States through the ESM was (for the first time in an explicit way) mentioned during the Euro Area Summit meeting, which was held concurrently on 28-29 June 2012. According to the relevant Statement:

‘When an effective Single Supervisory Mechanism (hereinafter the ‘SSM’)¹⁹⁷ is established, involving the ECB, for banks in the euro area the ESM could, following a regular Decision, have the possibility to recapitalise banks directly which would rely on appropriate conditionality, including compliance with State Aid rules.’¹⁹⁸

It is worth pointing out that this Euro Area Summit meeting is of utmost importance, due to the political Decisions taken for:

(i) *the creation of a ‘European Banking Union’ (hereinafter the ‘EBU’)¹⁹⁹, and*

(ii) *the invitation to the President of the European Council ‘to develop, in close collaboration with the President of the European Commission, the President of the Eurogroup and the President of the ECB, a specific and time-bound roadmap for the achievement of a genuine Economic and Monetary Union (hereinafter the ‘EMU’)²⁰⁰, in accordance with a relevant Report,²⁰¹ submitted to the EU institutions a few days earlier (on 26 June) by the President of the European Council.*

¹⁹⁷ For a comprehensive overview of the legal framework pertaining to the SSM, see **European Central Bank (2014)**, **Gortsos (2015)**, pp. 77-284 and **Hadjiemmanuil (2015)**, pp. 14-16.

¹⁹⁸ **Euro Area Summit Statement, 29 June 2012**, first paragraph, fourth sentence, available at: http://consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf

¹⁹⁹ The concept of the European Banking Union is based upon the following three (3) pillars:

- The SSM, with the ECB as the institution in charge,
- The Single Resolution Mechanism (the ‘SRM’), which deals with the restructuring and resolution of insolvent financial institutions, and
- The Single Deposit Guarantee Scheme (the ‘SDGS’), which is still pending.

Underpinning these three (3) pillars is the concept of a ‘Single Rulebook’, laying down uniform terms on all the above-mentioned aspects, such as:

- (i) the authorisation and withdrawal of credit institutions,
- (ii) the conduct of micro-prudential supervision over credit institutions,
- (iii) the resolution of insolvent credit institutions, and
- (iv) the operation of deposit guarantee schemes.

For more details, see **Gortsos (2013a)** and the various contributions in **Lastra, Krauskopf, Gortsos and Smits (2014)**. On the term ‘Single Rulebook’, see **European Council Conclusions, 18/19 June 2009**, 11225/2/09 REV 2, paragraph 20, first sentence, available at: <http://data.consilium.europa.eu/doc/document/ST-11225-2009-REV-2/en/pdf> and **Gortsos (2015)**, p. 42.

²⁰⁰ For a comprehensive overview of the historical aspects and the basic concepts of the EMU, see indicatively **Louis (2013)**, pp. 1-15. On the main legal texts pertaining to the EMU, see **European Commission (2014)**.

²⁰¹ This Report, known as the ‘Van Rompuy Report’, was finalised and subsequently submitted to the EU institutions on 5 December 2012. One of the four (4) key elements was the creation of the EBU, while the other three (3) were the establishment of:

In addition, those Decisions were the ‘triggering effect’ for the European Commission to issue on 12 September 2012, *inter alia*, a proposal for a Council Regulation ‘conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions’.²⁰²

(b) Subsequently, the Joint Statement of the Ministers of Finance of Germany, the Netherlands and Finland, as a result of a meeting held on 25 September 2012, laid down the following on this particular issue:

‘Principles that should be incorporated in design of this instrument for direct recapitalisation include:

- Direct recapitalisation Decisions need to be taken by a regular Decision of the ESM, accompanied by the signing of a relevant MoU.
- The ESM can take direct responsibility of problems that occur under the new supervision regime, but legacy assets should be under the responsibility of national authorities.
- The recapitalisation should always occur using real economic values.
- Direct recapitalisation of credit institutions by the ESM should take place based on an approach that adheres to the basic order of first using private capital, then national public capital and only as a last resort the ESM.’

It is worth pointing out that a necessary precondition for the use of the DRI was the establishment of the SSM and the subsequent determination of its effectiveness.²⁰³

Nevertheless, no further action was taken during 2012, regarding the establishment of the DRI.

(c) Thus, under the regime in place until 8 December 2014, the ESM could provide financial assistance towards its Members for the specific purpose of recapitalising credit institutions only *indirectly* and under the conditions laid down in **Article 15** of the **ESM Treaty**, in accordance with the above-mentioned (under 1(a)).²⁰⁴

2.2 The Decisions of June 2013

(a) Following the Euro Area Summit Statement on 28-29 June 2012, which reaffirmed, *inter alia*, the need to break the ‘vicious circle’ between banks and sovereigns,²⁰⁵ the Eurogroup worked extensively on the operational framework of the

-
- an integrated budgetary framework (a ‘European Fiscal Union’),
 - an integrated economic policy framework (a ‘European Economic Union’), and
 - a democratic legitimacy and accountability framework (a ‘European Political Union’).

The Report is available at:

http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/134069.pdf

²⁰² For a detailed presentation of the European Commission proposals issued on 12 September 2012, see **Gortsov (2012b)**.

²⁰³ This Joint Statement is available at: <https://zoek.officielebekendmakingen.nl/blg-186965.pdf>

²⁰⁴ As of March 2015, the ‘*Indirect* Recapitalisation Instrument’ has been used twice, in particular in the case of the recapitalisation of the Spanish banking sector and the Cypriot co-operative banking sector. For more details on these financial assistance programmes, see indicatively **European Stability Mechanism (2013)**, pp. 21 and 17, respectively.

²⁰⁵ **Euro Area Summit Statement, 29 June 2012**, first paragraph, first sentence.

DRI. Thus, the main features of the DRI were preliminarily agreed upon during the Eurogroup meeting, which was held in Luxembourg on 20 June 2013, in view of having this instrument operational once the SSM came into force.²⁰⁶

(b) In order to reflect the close interrelation between the various legal acts of the EU banking law (i.e. the Bank Recovery and Resolution Directive (hereinafter the ‘**BRRD**’)²⁰⁷ and the Deposit Guarantee Scheme Directive (hereinafter the ‘**DGSD**’)),²⁰⁸ it was (then) proposed that the operational framework of the DRI be finalised (including the relevant Guideline), as soon as the above-mentioned legislative proposals have been finalised and, subsequently, published in the Official Journal of the EU (the ‘OJ’).

(c) After finalisation of the operational framework and following the completion of the necessary national procedures by the euro area Member States, the Board of Governors would add the DRI to the list of the ESM financial assistance instruments, in accordance with the provisions laid down in **Article 19** of the **ESM Treaty**, via Resolution, taken by mutual agreement, i.e. unanimity (on this procedure *see* above, under A, 2.2.1.2(a) and (d)). Furthermore, it was agreed that Decisions granting financial assistance through the DRI would also be taken by mutual agreement.

(d) In a nutshell, the following key elements were agreed by the Eurogroup and would (thus) be reflected in the operational framework of the DRI, when adopted:

- its objective,
- the eligibility criteria for the ESM Member, as well as for the credit institution concerned (including the conduct of a thorough ‘due diligence’ and rigorous economic valuation of the institution’s assets),
- its *ex ante* limit,
- its financial architecture, including an appropriate burden sharing structure and the form of capital instruments to be used,
- its economic policy conditionality,
- aspects regarding the governance of the institution benefitting from the DRI, as well as the governance arrangements for the proper implementation of this instrument, and
- other aspects, including the ongoing review of its relevant Guideline and its potential retroactive application.

²⁰⁶ The main features of the DRI agreed upon in this Eurogroup meeting are available at:

<http://www.eurozone.europa.eu/media/436873/20130621-ESM-direct-recaps-main-features.pdf>

²⁰⁷ **Directive 2014/59/EU** of the European Parliament and of the Council of 15 May 2014 ‘*establishing a framework for the recovery and resolution of credit institutions (...)*’ (OJ L 173, 12.6.2014, pp. 190-348). For a detailed analysis of the *new* EU resolution framework, *see* indicatively **European Central Bank (2011b)**, pp. 85-94, **Micossi, Bruzzone and Carmassi (2013)** and **Bank of England (2014)**.

²⁰⁸ **Directive 2014/49/EU** of the European Parliament and of the Council of 16 April 2014 ‘*on deposit guarantee schemes*’ (OJ L 173, 12.6.2014, pp. 149-178). For a detailed analysis of this Directive, *see* **Gortsos (2014)**, pp. 29-138.

3. The provisions of the Guideline on the DRI²⁰⁹

3.1 Introductory remarks

(a) On 10 June 2014, the euro area Member States reached a preliminary agreement on the content of the DRI. This instrument became fully operational on 8 December 2014, after the completion of the necessary national procedures by the euro area Member States, by a unanimous Resolution of the Board of Governors.²¹⁰

(b) This Resolution was adopted pursuant to **Article 19** of the **ESM Treaty**, in accordance with the above (under A, 2.2.1.2(d)), which reads as follows:

*‘The Board of Governors may review the list of financial assistance instruments provided for in **Articles 14 to 18** therein and decide to make changes to it.’*

(c) On the same day, the Board of Directors adopted a detailed Guideline on:

- the modalities, including, in particular, the eligibility criteria for the requesting ESM Member and the institution concerned, and
- the allocation of specific tasks to the Managing Director of the ESM, the European Commission, the ECB and, whenever appropriate, the IMF, for implementing financial assistance in the form of DRI.²¹¹

3.2 General provisions

(I) Scope of the DRI

(a) According to **Article 1** of the relevant Guideline, the Board of Governors may decide to grant financial assistance to *directly* recapitalise institutions at the request of an ESM Member.²¹²

*In terms of definitions, ‘institutions’ are defined with reference to **Article 2, points (3) to (5) of the Council Regulation (EU) No 1024/2013 of 15 October 2013 ‘conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions’**²¹³ (hereinafter the ‘SSM Regulation’):²¹⁴*

(1) *‘credit institution’ means ‘an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account.’²¹⁵*

(2) *‘financial holding company’ means ‘a financial institution.’*

²⁰⁹ For a general overview of the legal framework pertaining to the DRI, see **Hadjiemmanuil (2015)**, pp. 29-34.

²¹⁰ This Resolution is available at: <http://www.esm.europa.eu/pdf/Establishment%20of%20the%20instrument%20for%20the%20direct%20recapitalisation%20of%20insti%20%20%20.pdf>

²¹¹ This Guideline is available at: <http://www.esm.europa.eu/pdf/20141208%20Guideline%20on%20Financial%20Assistance%20for%20the%20Direct%20Recapitalisation%20of%20Institutions.pdf>

²¹² **Guideline on Financial Assistance for the DRI**, Article 1, paragraph 1, first sentence.

²¹³ OJ L 287, 29.10.2013, pp. 63-89. For a detailed analysis of this Regulation, see **Gortsos (2015)**, pp. 77-284.

²¹⁴ **Guideline on Financial Assistance for the DRI**, Article 1, paragraph 1, second sentence.

²¹⁵ This definition is provided with further reference to Article 4, paragraph 1, point (1) of **Regulation (EU) No 575/2013** (on this, see above, under footnote 36).

- *the subsidiaries of which are exclusively or mainly credit institutions, investment firms or financial institutions, at least one of such subsidiaries being a credit institution or an investment firm, and*
 - *which is not a mixed financial holding company.*²¹⁶
- (3) *'mixed financial holding company' means 'a parent undertaking, other than a regulated entity, which, together with its subsidiaries-at least one of which is a regulated entity, which has its registered office in the EU- and other entities, constitutes a financial conglomerate.'*²¹⁷

Unless otherwise indicated, hereinafter any reference to the term 'institution(s)' in the text of this paper is made to all the above-mentioned three (3) types of financial institutions.

The financial assistance towards the above-mentioned forms of institutions may be requested by the ESM Members within or outside the confines of a macroeconomic adjustment programme.²¹⁸ Furthermore, it must be subject to appropriate conditionality, the nature of which must be:

- institution-specific,
- sector-specific, and/or
- macroeconomic.²¹⁹

(b) Such financial assistance must be provided:

- for the specific purpose of *direct* recapitalisation of institutions established in an ESM Member, and
- in accordance with the State Aid provisions laid down in **Articles 107 and 108 TFEU**.²²⁰

(c) In exceptional cases, if an ESM Member is already the beneficiary of financial assistance provided by the ESM and requires use of additional financial support instruments, the existing MoU must be revised:

- to include conditionality needed for the DRI, and
- to assess whether:
 - (i) the conditionality already used is still appropriate, or
 - (ii) changes are required.²²¹

²¹⁶ This definition is provided with further reference to Article 4, paragraph 1, point (20) of **Regulation (EU) No 575/2013**.

²¹⁷ This definition is provided with further reference to Article 2, point (15) of **Directive 2002/87/EC** of the European Parliament and of the Council of 16 December 2002 '*on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate*' (OJ L 35, 11.2.2003, pp. 1-27). For a detailed analysis of this Directive, see indicatively **Gortsos (2010)**, pp. 295-313.

²¹⁸ **Guideline on Financial Assistance for the DRI**, Article 1, paragraph 4, first sentence.

²¹⁹ *Ibid.*, Article 1, paragraph 4, second sentence.

²²⁰ *Ibid.*, Article 1, paragraphs 2 and 3. For a detailed analysis on the application of these provisions within the financial system, see indicatively **Austin (2012)** and **Micossi, Bruzzone and Cassella (2014)**.

²²¹ **Guideline on Financial Assistance for the DRI**, Article 1, paragraph 5, first sentence.

Subsequently, the Decision whether to provide additional financial assistance in the form of the DRI must be taken, in accordance with the provisions and procedures laid down in the relevant Guideline.²²²

(d) Finally, the provisions laid down in the relevant Guideline are without prejudice to the possibility that a non-requesting ESM Member may provide national financial assistance to a subsidiary of an institution established in its territory even if ESM support is requested for a parent undertaking.²²³ Again, this assistance must be provided in accordance with the State Aid provisions laid down in **Articles 107 and 108 TFEU**.²²⁴

(II) Aim of the DRI

(a) As a general rule, the aim of the DRI is the preservation of the financial stability of the euro area as a whole and of its Member States, by catering for those specific cases in which an ESM Member experiences acute difficulties with its financial sector that cannot be remedied without significantly endangering its fiscal sustainability due to a severe risk of contagion from the financial sector to the sovereign.²²⁵

Thus, such financial assistance must seek to remove the risk of contagion from the financial sector to the sovereign, thereby reducing the effect of a ‘vicious circle’ between a ‘fragile’ financial sector and a deteriorating creditworthiness of the sovereign.²²⁶

(b) In exceptional cases, the use of this instrument may also be considered, if other alternatives would have the effect of endangering the continuous market access of an ESM Member.²²⁷

(c) The financial assistance granted to institutions under this form of stability support must be restricted to the specific purpose of *direct* recapitalisation, while requiring fulfilment of appropriate conditionality, accompanied by a relevant MoU, addressing both:

- the sources of difficulties in the financial sector, and
- (where appropriate) the general economic situation of the requesting ESM Member.²²⁸

(d) Finally, the use of the DRI for the financing of winding-up proceedings of the institution(s) concerned is strictly prohibited.²²⁹

²²² *Ibid.*, Article 1, paragraph 5, second sentence.

²²³ *Ibid.*, Article 1, paragraph 6, first sentence.

²²⁴ *Ibid.*, Article 1, paragraph 6, second sentence.

²²⁵ *Ibid.*, Article 2, paragraph 1, first sentence.

²²⁶ *Ibid.*, Article 2, paragraph 1, third sentence.

²²⁷ *Ibid.*, Article 2, paragraph 1, second sentence.

²²⁸ *Ibid.*, Article 2, paragraph 2.

²²⁹ *Ibid.*, Article 2, paragraph 3. The winding-up proceedings in the EU fall within the Member States competence and are governed by the provisions laid down in **Directive 2001/24/EC** of the European Parliament and of the Council of 4 April 2001 ‘*on the reorganisation and winding-up of credit institutions*’ (OJ L 125, 5.5.2001, pp. 15-23). For more details of this Directive, see **Gortsos (2015)**, pp. 65-66.

(III) Eligibility criteria

(a) In order for a request for financial assistance for the purpose of the DRI to be considered eligible, *all* the following criteria related to the requesting ESM Member must be *fully* met:

- the requesting ESM Member is unable to provide financial assistance to the institutions in full without inducing adverse effects on its own fiscal sustainability (including the *indirect* recapitalisation instrument, in accordance with the above-mentioned, under 1(a)), and
- providing financial assistance to the benefit of that requesting ESM Member is considered indispensable to safeguard the financial stability of the euro area as a whole or of its Member States.²³⁰

(b) In order for a request for financial assistance for the purpose of the DRI to be considered eligible, *all* the following criteria related to the relevant institution(s) must be *fully* met:

- it has a systemic relevance²³¹ or poses a serious threat to the financial stability of the euro area as a whole or of the requesting ESM Member,
- it is (or is likely to be in the near future) in breach of the capital requirements established by the ECB as the single supervisory authority within the SSM, and
- it is unable to obtain sufficient capital from private sources, if a ‘bail-in’²³² would not be sufficient to meet the anticipated capital shortfall.²³³

*On the DRI eligibility preconditions for the requesting Member State(s) and the institution(s) concerned, see below **Table 8**.*

(c) Prior to any Decision to grant stability support in the form of the DRI, compliance with the above-mentioned criteria must be assessed in accordance with the

²³⁰ **Guideline on Financial Assistance for the DRI**, Article 3, paragraph 2. The use of the DRI may also be considered if it is established that other alternatives would have the effect of endangering the continuous market access of the requesting ESM Member and, consequently, require the financing of its sovereign needs via the ESM (*Ibid*).

²³¹ The systemic dimension of these institutions is assessed taking into account, primarily the following factors:

- size,
- interconnectedness,
- complexity, and
- substitutability.

Thus, systemic relevance can refer to:

- (i) systemically important institutions, and/or
- (ii) other institutions, not necessarily cross-border, whose insolvency could have a significant negative impact on the financial system due to adverse market circumstances or financial stress (*Ibid.*, Article 3, paragraph 1).

²³² This resolution tool is further analysed in Articles 43-62 of the **BRRD**. For more details, see indicatively **Financial Stability Board (2014)**, pp. 6-11.

²³³ **Guideline on Financial Assistance for the DRI**, Article 3, paragraph 1.

provisions laid down in **Article 4, paragraph 2** of the relevant Guideline (*see* just below, under 3.3(I)(b)).²³⁴

| TABLE 8 | |
|--|---|
| DRI eligibility preconditions | |
| Member State | Institution |
| Unable to rescue without adverse effects on fiscal sustainability and market access | Is or likely to be in breach of capital requirements |
| Assistance must be indispensable to protect financial stability the euro area and/or its Member States | Viability depends on capital injection and restructuring needs |
| - | Unable to attract sufficient capital from private sources |
| - | Systemic relevance and/or posing a serious threat to the financial stability of the euro area |

3.3 Procedural provisions

(I) Procedures for granting support under the provisions of Article 4

(a) An ESM Member must address a request for financial assistance to the Chairperson of the Board of Governors. Such a request must provide:

- an indication of the institution(s) in distress for which financial assistance is being requested,
- possible amount of capital needs, taking into account the implementation of the bail-in instrument, in accordance with the provisions laid down in **Article 8** of the relevant Guideline (on the implementation of this resolution tool, *see* below, under 3.4.3),
- an opinion from the competent supervisory authority on the financial situation of the institution(s) in distress,
- the result of the most recent stress test, conducted by the relevant competent supervisory authority, and
- the result of the most recent stress test of all other relevant institutions in the requesting ESM Member, if deemed necessary by the European Commission or the Managing Director of the ESM.²³⁵

(b) Upon receipt of such request, and as a necessary precondition for the use of the DRI, the Board of Governors must address, without undue delay, to the ECB the request foreseen in the provisions laid down in **Article 33, paragraph 3** (second subparagraph) of the **SSM Regulation**, in case the *latter* is not already the competent supervisory authority of the institution concerned.²³⁶

²³⁴ *Ibid.*, Article 3, paragraph 3.

²³⁵ *Ibid.*, Article 4, paragraph 1.

²³⁶ *Ibid.*, Article 4, paragraph 2, first sentence. It is worth pointing out that this Decision of the Board of Governors requesting the ECB to assume its supervisory tasks on the institution

Article 33, paragraph 3 (second sub-paragraph) of the **SSM Regulation** states in this respect:

‘(...) if the ESM unanimously requests the ECB to take over direct supervision of a credit institution, financial holding company or mixed financial holding company as a precondition for its direct recapitalisation²³⁷, the ECB may immediately start carrying out the tasks conferred on it by this Regulation in respect of that credit institution, financial holding company or mixed financial holding company, and following a Decision addressed to the entities concerned and to the national competent authorities concerned.’

In addition, the Chairperson of the Board of Governors must entrust:

(i) the European Commission, in liaison with the ECB and (wherever appropriate) the IMF, to conduct:

- the necessary assessments as described in the provisions laid down in **Article 13, paragraph 1** of the **ESM Treaty** (on the content of these assessments *see* above, under 1(c)(ii)), and
- the necessary assessments as described in the provisions laid down in **Article 3, paragraph 2** of the relevant Guideline (on the content of these assessments *see* above, under 3.2(III)(a)).

(ii) together with the Managing Director of the ESM, the competent resolution authority and the ECB in its capacity as the single supervisory authority within the SSM, to assess the respect of the eligibility criteria as described in the provisions laid down in **Article 3, paragraph 1** of the relevant Guideline (on the content of those eligibility criteria *see* above, under 3.2(III)(b)).²³⁸

(c) Based on the above-mentioned assessments, the Board of Governors, upon a proposal from the Managing Director of the ESM, must decide whether the eligibility criteria are met, and, if so, to grant, in principle, financial assistance to the benefit of the ESM Member concerned.²³⁹

Following the above-mentioned Decision, the ESM Member concerned must notify, pursuant to the provisions laid down in **Article 108, paragraph 3 TFEU**, the European Commission of its intention to grant State Aid within the meaning of **Article 107, paragraph 1** therein.²⁴⁰

Articles 107, paragraph 1 and **108, paragraph 3 TFEU** make the following considerations (respectively):

‘Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favoring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market.’

concerned must have no bearing on any future Decision as to the granting of financial assistance (*Ibid.*, Article 4, paragraph 2, second sentence).

²³⁷ On the current debate regarding the recapitalisation of credit institutions *directly* supervised by the SSM, *see* indicatively the various contributions in **Whelan, Wolff, Merler, Dalusio, Gros, Eijffinger and Raes (2014)**.

²³⁸ **Guideline on Financial Assistance for the DRI**, Article 4, paragraph 2, third sentence.

²³⁹ *Ibid.*, Article 4, paragraph 3.

²⁴⁰ *Ibid.*, Article 4, paragraph 4, first sentence.

*'The European Commission shall be informed, in sufficient time to enable it to submit its comments, of any plans to grant or alter aid. If it considers that any such plan is not compatible with the internal market having regard to **Article 107**, it shall without delay initiate the procedure provided for in **paragraph 2 of Article 108** therein. The Member State concerned shall not put its proposed measures into effect until this procedure has resulted in a final decision.'*

*It should be noted that during this notification procedure the ESM must act as an agent for the ESM Member concerned through the establishment of proper arrangements containing certain provisions obliging that ESM Member to effectively enforce any Decision taken by the European Commission, pursuant to the above-mentioned **TFEU** provisions.²⁴¹*

(d) As a necessary precondition²⁴² for the disbursements of the tranches of the financial assistance in the form of the DRI, the ESM must draw up a restructuring plan ensuring the viability of the institution after the completion of the recapitalisation and restructuring processes. This task must be conducted:

- jointly with the institution(s) and the ESM Member concerned, and
- after having consulted the ECB in its capacity as the single supervisory authority within the SSM, as well as the competent resolution authority.²⁴³

Subsequently, the main elements of the draft restructuring plan must be presented to the Board of Directors for approval before submission to the European Commission.²⁴⁴

(e) In parallel, the Managing Director of the ESM, in liaison with the European Commission and the ECB in its capacity as the single supervisory authority within the SSM, must (as a general principle) conduct a due diligence exercise with the assistance of independent experts aimed at determining:

- the institution's viability, and
- its loss absorption potential.²⁴⁵

(f) Moreover, the Board of Governors must, in accordance with the provisions laid down in **Article 13, paragraph 3** of the **ESM Treaty**, as mentioned above (under 1(c)), entrust:

(i) the European Commission, alongside the ECB, the Managing Director of the ESM and, (wherever appropriate) the IMF, with the task of negotiating with the ESM Member concerned a relevant MoU detailing:

- the policy conditions related to its financial sector, and
- several other aspects, such as its micro-prudential supervision, corporate governance model of institutions, as well as relevant provisions pertaining the applicable national law, where appropriate.²⁴⁶

²⁴¹ *Ibid.*, Article 4, paragraph 4, second and third sentences.

²⁴² *Ibid.*, Article 4, paragraph 11.

²⁴³ *Ibid.*, Article 4, paragraph 5, first sentence. The ESM Member concerned must ensure the delivery of any necessary information in a timely manner (*Ibid.*, Article 4, paragraph 5, second sentence).

²⁴⁴ *Ibid.*, Article 4, paragraph 5, third sentence.

²⁴⁵ *Ibid.*, Article 4, paragraph 6.

(ii) the Managing Director of the ESM, in liaison with the European Commission, the ECB in its capacity as the single supervisory authority within the SSM and the requesting ESM Member, with the task of establishing institution-specific conditions unrelated to the provisions of **Articles 107** and **108 TFEU**. Such conditions may include, *inter alia*, restrictions upon:

- the remuneration of senior management, and
- the dividend policy of the institution concerned.²⁴⁷

(iii) again, the Managing Director of the ESM, alongside the European Commission, the ECB and the requesting ESM Member, with the task of preparing a proposal (to be adopted by the Board of Governors) for the establishment of a Financial Facility Agreement detailing the financial assistance, and in particular:

- the envisaged amounts to be provided to the institutions concerned, including the financial terms and conditions, and
- the type of financial instruments and the obligations of the requesting ESM Member.²⁴⁸

(g) Subsequently, the proposals for the institution-specific conditions and the Financial Facility Agreement must be submitted for approval to the Board of Governors.²⁴⁹

Nevertheless, in case financial assistance has been requested for several institutions and the finalisation of an institution-specific agreement is delayed, then the related proposal will be submitted at a *later* stage in parallel with a proposal to amend the relevant Financial Facility Agreement, if required.²⁵⁰

(h) Finally, the European Commission is entrusted with the signing of the relevant MoU on behalf of the ESM.²⁵¹

This is without prejudice to prior compliance with the conditions set out in the provisions laid down in **Article 4, paragraph 7** of the relevant Guideline, as mentioned above (under 3.3(I)(f)), and approval by the Board of Governors.²⁵²

²⁴⁶ *Ibid.*, Article 4, paragraph 7, point (a). Such policy conditions may also include, where appropriate, requirements related to the general economic policy of the ESM Member concerned.

²⁴⁷ *Ibid.*, Article 4, paragraph 7, point (b). Such conditions together with the financial instruments to be utilised for the DRI, must be described in a proposal, to be adopted by the Board of Governors, for an institution-specific agreement to be established between the ESM, requesting ESM Member and the institution(s) concerned.

²⁴⁸ *Ibid.*, Article 4, paragraph 7, point (c). Such proposal for the establishment of a Financial Facility Agreement must contain, *inter alia*, the overall maximum amount of the assistance for the benefit of the requesting ESM Member, taking into account:

- the results of the due diligence exercise, in accordance with the above-mentioned (under 3.3(I)(e)), and
- the necessary capital level determined by the ECB in its capacity as the single supervisory authority within the SSM (on this *see* just below, under 3.3(II)(b)).

²⁴⁹ *Ibid.*, Article 4, paragraph 8, first sentence.

²⁵⁰ *Ibid.*, Article 4, paragraph 8, second sentence.

²⁵¹ *Ibid.*, Article 4, paragraph 9.

²⁵² *Ibid.*

Accordingly, the Board of Directors must approve:

- the Financial Facility Agreement and the respective institution-specific agreement(s) to be signed by the Managing Director of the ESM, and
- the disbursement of the first tranche of the financial assistance within the context of the DRI.²⁵³

It should be noted, however, that (where applicable) such approval may be made subject to the condition that any prior actions stipulated within the institution-specific conditions of financial assistance set in the institution-specific agreement are fulfilled.

(II) Valuation of the institution under the provisions of Article 7

(a) Before providing financial assistance and in line with the provisions laid down in **Article 4, paragraph 6** of the relevant Guideline, in accordance with the above (under 3.3(I)(e)), the Managing Director of the ESM, in liaison with the European Commission and the ECB in its capacity as the single supervisory authority within the SSM, must (as a general principle) conduct (with the assistance of independent experts):

- a thorough due diligence,
- a stress test, and
- a rigorous economic valuation of the institution's assets,

in order to determine the amount of incurred, expected and unexpected losses, as well as the institution's loss absorption capacity, taking into account the level of bail-in conducted in accordance with the provisions laid down in **Article 8** of the relevant Guideline (on the implementation of this resolution tool, *see* below, under 3.4.3) and its viability in addition to providing the basis for pricing the ESM capital injection.²⁵⁴

(b) Taking into account a possible participation from private investors, the capital injected by the ESM and, as a general rule, the ESM Member concerned must be of the amount required to reach the necessary capital level as determined by the ECB in its capacity as the single supervisory authority within the SSM.²⁵⁵

(c) Upon a proposal of the Managing Director based on an analysis of all necessary information and after having consulted the European Commission and the ECB in its capacity as the single supervisory authority within the SSM, the Board of Governors may decide (as part of the Decision taken under the provisions laid down in **Article 13, paragraph 2** of the **ESM Treaty**, on this procedure, *see* above, under 1(c)) to make use of:

- the results of the conducted stress test, and/or
- the rigorous economic valuation already conducted by the ECB in its capacity as the single supervisory authority within the SSM.

This is without prejudice to the finalisation of the above-mentioned key elements within three (3) months prior to the official request by the ESM Member concerned.²⁵⁶

²⁵³ *Ibid.*, Article 4, paragraph 10.

²⁵⁴ *Ibid.*, Article 7, paragraph 1, first sentence.

²⁵⁵ *Ibid.*, Article 7, paragraph 2.

²⁵⁶ *Ibid.*, Article 7, paragraph 1, second sentence.

3.4 Implementation of the DRI

3.4.1 Introductory remarks

(a) The ESM must provide the financial assistance as described in the financial assistance agreement and the institution-specific agreement.²⁵⁷ Accordingly, the ESM Member concerned must adopt all agreed measures required for the implementation of the recapitalisation plan.²⁵⁸

(b) Such financial assistance may be provided in several tranches, which may each consist of one (1) or more disbursements.²⁵⁹

(c) Subsequent to the first tranche, disbursements of further tranches must be made upon a formal Decision taken by mutual agreement by the Board of Directors, following a proposal from the Managing Director of the ESM, and after having received the report conducted by the European Commission, in liaison with the ECB and the ESM, in accordance with its monitoring procedure, as described in the provisions laid down in **Article 5** of the relevant Guideline (on this procedure, *see* below, under 3.4.7).²⁶⁰

3.4.2 Duties of the subsidiary body and participation of the private sector in the DRI

The ESM subsidiary body established, through a unanimous Decision taken by the Board of Governors and subject to its approval, may be entrusted to undertake the recapitalisation operations. In order to enable external investors to participate in the recapitalisation alongside the ESM, the Board of Governors may also establish sub-entities dedicated to the financing, implementation and ownership of capital instruments related to the recapitalisation process.²⁶¹

3.4.3 Application of the ‘bail-in’ instrument

(a) As a general rule, the DRI is prohibited from being used as a precautionary instrument as defined in the provisions laid down in:

- **Article 32, paragraph 4, point (d), third indent** of the **BRRD**, and
- **Article 18, paragraph 4, point (d), third indent** of the **Regulation (EU) No 806/2014**²⁶² of the European Parliament and of the Council of 15 July 2014 ‘*establishing uniform rules and a uniform procedure for the resolution of credit institutions (...) in the framework of a Single Resolution Mechanism*²⁶³ and a *Single Resolution Fund (...)*’ (hereinafter the ‘SRM Regulation’).²⁶⁴

Article 32, paragraph 4, point (d), third indent of the **BRRD** states in this respect:

²⁵⁷ *Ibid.*, Article 6, paragraph 1, first sentence.

²⁵⁸ *Ibid.*, Article 6, paragraph 1, second sentence.

²⁵⁹ *Ibid.*, Article 6, paragraph 2.

²⁶⁰ *Ibid.*, Article 6, paragraph 3.

²⁶¹ *Ibid.*, Article 13.

²⁶² OJ L 225, 30.7.2014, pp. 1-90.

²⁶³ For a general overview of the legal framework pertaining to the SRM, *see* indicatively **Gortsos (2015)**, p. 53 and **Hadjiemmanuil (2015)**, pp. 16-18.

²⁶⁴ **Guideline on Financial Assistance for the DRI**, Article 8, paragraph 1.

'For the purposes of the determination that an institution is failing (or is likely to fail), which has been made by the competent authority, after consulting the resolution authority, an institution must be deemed as such if:

(...)

(d) extraordinary public financial support is required except when, in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability, the extraordinary public financial support takes the form of:

(...)

(iii) an injection of own funds or purchase of capital instruments at prices and on terms that do not confer an advantage upon the institution, where neither the circumstances referred to in point (a), (b) or (c) of paragraph 4 nor the circumstances referred to in Article 59, paragraph 3 therein are present at the time the public support is granted.'

Accordingly, **Article 18, paragraph 4, point (d), third indent** of the **SRM Regulation** stipulates that:

'For the purposes of an entity, which is failing (or is likely to fail), the entity must be deemed as such if:

(...)

(d) extraordinary public financial support is required except where, in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability, that extraordinary public financial support takes the form of:

(...)

(iii) an injection of own funds or purchase of capital instruments at prices and on terms that do not confer an advantage upon the entity, where neither the circumstances referred to in points (a), (b) and (c) of paragraph 4 nor the circumstances referred to in Article 21, paragraph 1 therein are present at the time the public support is granted.'

Thus, any precautionary public assistance in the form of participation in the equity of an institution, which is still solvent will need to take place under the responsibility of the relevant national government and on its own account.

(b) For a transitional period (until 30 December 2015) the following waterfall must apply as a necessary precondition for the use of the DRI:

(i) a contribution to loss absorption and recapitalisation equal to an amount of 8% of the total liabilities (including own funds of the institution under the resolution process, measured at the time of resolution action) has been made by:

- shareholders and the holders of other instruments of ownership,
- the holders of relevant capital instruments, and
- other eligible liabilities through write-down or conversion processes.

(ii) thereafter, use of the national resolution fund sources (or national financing arrangements set up in accordance with the provisions laid down in **Article 100, paragraph 6** of the **BRRD**) up to the pre-arranged 2015 target level.²⁶⁵

(c) From 1 January 2016 onwards, the following waterfall, as defined in the provisions laid down in the **SRM Regulation**, must apply as a necessary precondition for the use of the DRI:

²⁶⁵ *Ibid.*, Article 8, paragraph 2.

(i) a contribution to loss absorption and recapitalisation equal to an amount not less than 8% of the total liabilities (including own funds of the institution under the resolution process, measured at the time of resolution action) has been made by:

- shareholders,
- the holders of relevant capital instruments, and
- other eligible liabilities through write-down or conversion processes.

(ii) thereafter, a contribution of the Single Resolution Fund²⁶⁶ (hereinafter the ‘SRF’) of no more than 5% of the total liabilities (including own funds of the institution under the resolution process, measured at the time of the resolution action) has been made, and

(iii) all unsecured and non-preferred liabilities (other than eligible deposits), have been written-down or converted in full.²⁶⁷

3.4.4 Contribution of the ESM Member to the Recapitalisation Operation

(a) During the recapitalisation operations, a so-called ‘burden-sharing scheme’ determines the contributions of the requesting ESM Member and the ESM. Thus, the ESM Member must contribute a level of capital alongside the ESM.²⁶⁸

This scheme comprises the following two (2) parts:

- if the institution has insufficient equity to reach the legal minimum Common Equity Tier 1²⁶⁹ (‘CET 1’) ratio of 4.5% under a sufficiently prudent scenario under an individual stress test of the institution, the requesting ESM Member must be required to implement a one-off capital injection to reach the above-mentioned capital ratio, before the ESM enters into the capital of the institution, or
- if the institution has sufficient equity to reach the legal minimum Common Equity Tier 1 (‘CET 1’) ratio of 4.5%, the requesting ESM Member must be required to make a capital contribution before the ESM enters into the capital of the institution.

During the first two (2) years following the entry into force of the DRI, said contribution of the ESM Member must be the equivalent of 20% of the total amount of the public contribution to the recapitalisation operation and the equivalent of 10% thereafter.²⁷⁰

Nevertheless, if the contribution of the requesting ESM Member (required to implement a one-off capital injection to reach the Common Equity Tier 1 (‘CET 1’) ratio of 4.5%) is below:

²⁶⁶ The SRF is intended to provide the primary source of financing for the resolution of unviable credit institutions within the context of the EBU. For a general overview of the legal framework pertaining to this Fund, see indicatively Gortsos (2015), p. 54 and Hadjiemmanuil (2015), pp. 26-29.

²⁶⁷ **Guideline on Financial Assistance for the DRI**, Article 8, paragraph 3.

²⁶⁸ *Ibid.*, Article 9, paragraph 1.

²⁶⁹ **Regulation (EU) No 575/2013**, Articles 26-61.

²⁷⁰ **Guideline on Financial Assistance for the DRI**, Article 9, paragraph 1.

- the equivalent of 20% of the total amount of the public to the recapitalisation operation during the first two (2) years following the entry into force of the DRI, and
- the equivalent of 10% thereafter that would have been required,

then it must inject an additional amount alongside the ESM to cover this difference.²⁷¹

(b) In exceptional cases, if the requesting ESM Member is (due to its fiscal position as well as significant implications upon market access) unable to fully provide its contribution to the recapitalisation process, the Board of Governors may (by mutual agreement) decide to (partially or fully) suspend the contribution mentioned above on the condition that:

(i) the ESM Member agrees to indemnify the ESM for any loss incurred on the share of capital that was acquired by the ESM in lieu of that ESM Member, and

(ii) the relevant MoU contains appropriate conditions of a macroeconomic nature, the details of which must be specified within the content of the relevant Financial Facility Agreement.²⁷²

On the DRI implementation process, see below **Table 9**.

(c) Finally, any loss incurred by the ESM in relation to the share of financial assistance provided in lieu of the ESM Member concerned, must be treated as a long-term loan. Again, the details of such agreement, including the maximum maturity of the loan, must be specified within the content of the relevant Financial Facility Agreement.²⁷³

| TABLE 9 | |
|--|---|
| DRI implementation process | |
| Resolution measures (i.e. bail-in) | |
| 1. Private Capital | 2. SRM |
| Appropriate level of debt restructuring, in line with EU state aid rules and the BRRD | From January 2016 onwards, up to 5% of an institution's concerned total liabilities |
| DRI | |
| 3. Member State | 4. ESM |
| Requesting Member State implements a one-off capital injection to reach a minimum Common Equity Tier 1 ('CET 1') ratio of 4.5% | Implements capital injection once the minimum Common Equity Tier 1 ('CET 1') ratio of 4.5% is reached and the requesting Member State contributes to the recapitalisation operation up to 20% of the total amount (in the first two (2) years following the entry into force of the DRI) and up to 10% afterwards |

²⁷¹ *Ibid.*, Article 9, paragraph 2.

²⁷² *Ibid.*, Article 9, paragraph 3.

²⁷³ *Ibid.*, Article 9, paragraph 4.

3.4.5 Capital instruments

(a) As a general rule, the DRI must be conducted against the acquisition of common shares that satisfy the Common Equity Tier 1 ('CET 1') requirement laid down in **Articles 28 and 29 of Regulation (EU) No 575/2013**.²⁷⁴

(b) Under exceptional circumstances, the Board of Governors may decide, as part of the Decision under the procedure laid down in **Article 13, paragraph 3** of the **ESM Treaty** (on this procedure, *see* above, under 1(c)):

(i) to depart from the general rule mentioned just above (under (a)) and authorise the acquisition of other capital instruments that satisfy the regulatory capital requirements (i.e. special shares, hybrid capital or contingent capital), in order to fulfil specific supervisory requirements.

In all circumstances in which the Board of Governors authorises the acquisition of other capital instruments, the ESM must also hold an appropriate level of common shares.

(ii) to depart from the general rule mentioned just above (under (a)) and authorise the issuance of guarantees, if strictly warranted for reducing the total cost of the recapitalisation, the use of which must not increase the probability of losses for the ESM as compared to the use of other capital instruments (*see* just above, under (b)(i)).

In all circumstances in which the Board of Governors authorises the issuance of guarantees, the ESM must hold an appropriate level of common shares.

(iii) to provide financial assistance, including via guarantees with full recourse to the requesting ESM Member, to:

- any 'bridge institution',²⁷⁵
- any 'asset management vehicle'²⁷⁶ resulting from the restructuring if warranted for reducing the total cost of the recapitalisation, or
- (if deemed crucial) the success of the recapitalisation operation by the ECB in its capacity as the single supervisory authority, within the SSM.²⁷⁷

3.4.6 Governance arrangements

(a) The ESM must be able to influence key aspects regarding the business model, as well as the governance of the institution benefitting from the DRI, including provisions pertaining to the risk framework. Such provisions on governance may include (but are not limited to):

- the faculty of assuring a sufficient information flow,
- the appointment and dismissal of members of management, and

²⁷⁴ *Ibid.*, Article 10, paragraph 1.

²⁷⁵ This resolution tool is further analysed in Articles 40-41 of the **BRRD**. For more details, *see* indicatively **Financial Stability Board (2014)**, pp. 6-11.

²⁷⁶ This resolution tool is further analysed in Article 42 of the **BRRD**. For more details, *see* indicatively **Financial Stability Board (2014)**, pp. 6-11.

²⁷⁷ **Guideline on Financial Assistance for the DRI**, Article 10, paragraph 2. It is worth pointing out that such assistance to asset management vehicles may only be provided in conjunction with assistance to the beneficiary institution that has transferred the assets and thus has a viable business model (*Ibid.*).

- imposing remuneration schemes for management that exclude excessive pay or bonuses.²⁷⁸

(b) In addition, the ESM influence must be realized through its representation in the institution as a shareholder, as well as through an institution-specific agreement between the ESM, the requesting ESM Member and the institution(s) concerned, detailing the appropriate institution-specific conditions, which needs to be signed before any financial assistance can be granted.²⁷⁹

(c) Finally, in order to avoid any impediments arising from the application of the relevant national law as well as to ensure the full exercise of the appropriate influence of the ESM, changes to the national legal framework of the ESM Member concerned (including the introduction of a bank recovery and resolution framework) must be imposed as part of the conditionality contained in the relevant MoU.²⁸⁰

3.4.7 Monitoring

3.4.7.1 General overview

(a) In order to adequately monitor compliance with the (institution-specific and all other policy) conditions:

- the ESM,
- the European Commission,
- the ECB, and
- any relevant experts or trustees authorised by them,

must have the right and the necessary powers to conduct on-site inspections in any beneficiary institution(s), in line with their respective competences.²⁸¹

(b) Under exceptional circumstances, when the DRI is implemented outside the confines of a macroeconomic adjustment programme, the European Commission must subject the ESM Member concerned to the so-called ‘enhanced surveillance regime’, in accordance with the provisions laid down in **Article 2, paragraph 3 of Regulation (EU) No 472/2013**²⁸² of the European Parliament and of the Council of 21 May 2013 ‘on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability’, if it has not already done so.²⁸³

Article 2, paragraph 3 of Regulation (EU) No 472/2013 states in this respect:

‘Where a Member State is in receipt of financial assistance on a precautionary basis from one or several other Member States or third countries, the EFSM, the ESM, the EFSF, or another relevant international financial institution, such as the IMF, the Commission shall subject that Member State to enhanced surveillance.

²⁷⁸ *Ibid.*, Article 11, paragraph 1.

²⁷⁹ *Ibid.*, Article 11, paragraph 2, first sentence.

²⁸⁰ *Ibid.*, Article 11, paragraph 2, second sentence.

²⁸¹ *Ibid.*, Article 5, paragraph 4.

²⁸² OJ L 140, 27.5.2013, pp. 1-10.

²⁸³ **Guideline on Financial Assistance for the DRI**, Article 5, paragraph 7.

The Commission shall make public its Decisions taken in accordance with paragraph 1 therein and with this paragraph.'

Subsequently, **Recital 5** of that Regulation makes the following considerations with regard to the 'enhanced surveillance regime':

'A Member State whose currency is the euro should be subject to enhanced surveillance under this Regulation when it is experiencing or is threatened with serious financial difficulties, with a view to ensuring its swift return to a normal situation and to protecting the other euro area Member States against potential adverse spill-over effects. Such enhanced surveillance should be proportionate to the seriousness of the problems and should be adjusted accordingly.

It should include wider access to the information needed for a close monitoring of the economic, fiscal and financial situation and a regular reporting to the competent committee of the European Parliament and to the Economic and Financial Committee²⁸⁴ (EFC) or to any subcommittee the latter may designate for that purpose.

The same arrangements for surveillance should apply to Member States requesting precautionary assistance from one or several other Member States or third countries, the European Financial Stabilisation Mechanism (EFSM), the European Stability Mechanism (ESM), the European Financial Stability Facility (EFSF), or another relevant international financial institution such as the International Monetary Fund (IMF).'

(c) Finally, the ESM must establish a so-called 'appropriate warning system',²⁸⁵ in accordance with the provisions laid down in **Article 13, paragraph 6** of the **ESM Treaty**, to ensure the proper receiving of any repayments due by the ESM Member under the procedure laid down in **Article 9, paragraph 4** of the relevant Guideline, as mentioned above (under 3.4.4(c)).²⁸⁶

3.4.7.2 Compliance with institution-specific conditions related to the provisions of Articles 107 and 108 TFEU

(a) As a general rule, monitoring of compliance with institution-specific conditions related to the provisions laid down in **Articles 107 and 108 TFEU** must be

²⁸⁴ The Economic and Financial Committee (known as the 'EFC') was established on the basis of the Maastricht Treaty, which provides for mandating a Committee to discuss the economic and financial issues arising in the third stage of the EMU, which began on 1 January 1999. The essential functions of this Committee are governed by the provisions laid down in Article 134 TFEU (ex Article 114 TEC) and the working arrangements are set out in:

- **Council Decision 98/743/EC** of 21 December 1998 'on the detailed provisions concerning the composition of the Economic and Financial Committee' (OJ L 358, 31.12. 1998, pp. 109-110), and
- **Council Decision 1999/8/EC** of 31 December 1998 'adopting the Statutes of the Economic and Financial Committee' (OJ L 5, 9.1.1999, pp. 71-73), as in force.

It is worth pointing out that before the third stage of the EMU, the EFC was preceded by the Monetary Committee, whose role was to promote policy coordination of the policies of the Member States to the extent needed for the functioning of the internal market.

For a general overview of the role of both Committees, see **Lastra (2013)**, p. 37 and http://europa.eu/efc/index_en.htm

²⁸⁵ The objective of this warning system is to determine the ability of the Member State, currently implementing a macroeconomic adjustment programme, to repay its loans. See on this **European Stability Mechanism (2014b)**.

²⁸⁶ **Guideline on Financial Assistance for the DRI**, Article 5, paragraph 6.

conducted by the European Commission.²⁸⁷ In order to achieve this, it may appoint a monitoring trustee to assist it in the monitoring process. Accordingly, this monitoring trustee must have the right to:

- sit on all relevant committees of the institution concerned, and
- have access to all relevant information.²⁸⁸

Subsequently, the European Commission is expected to make available to the Board of Directors and the ECB in its capacity as the single supervisory authority within the SSM information relevant to the reporting on compliance.²⁸⁹

(b) The institution-specific agreement must (wherever possible) contain appropriate contractual covenants related to non-compliance with the institution-specific conditions, including contractual financial sanctions.²⁹⁰ In case of non-compliance, the Board of Directors may, upon a proposal from the Managing Director of the ESM, enforce such covenants and, if deemed necessary, notify the ECB in its capacity as the single supervisory authority within the SSM of any violation of these conditions.²⁹¹

3.4.7.3 Compliance with institution-specific conditions unrelated to the provisions of Articles 107 and 108 TFEU

(a) As a general rule, monitoring of compliance with institution-specific conditions that are unrelated to the provisions laid down in **Articles 107 and 108 TFEU** must be conducted by the ESM, in liaison with the European Commission and the ECB in its capacity as the single supervisory authority within the SSM.²⁹² In order to achieve this, it may appoint a monitoring trustee, who must have the right to:

- sit on all relevant committees of the institution concerned, and
- have access to all relevant information.²⁹³

*It is worth pointing out, however, that this particular monitoring trustee need not be different from the one appointed by the European Commission and entrusted with the task of monitoring compliance with institution-specific conditions related to the provisions laid down in **Articles 107 and 108 TFEU**, according to the above-mentioned (under 3.4.7.2).²⁹⁴*

Subsequently, the Managing Director of the ESM must provide details on the institution's compliance with the institution-specific conditions monitored by the ESM and its trustee, if any, to the Board of Directors to the extent possible on a quarterly

²⁸⁷ *Ibid.*, Article 5, paragraph 1, first sentence.

²⁸⁸ *Ibid.*, Article 5, paragraph 1, second sentence.

²⁸⁹ *Ibid.*, Article 5, paragraph 1, third sentence.

²⁹⁰ *Ibid.*, Article 5, paragraph 8, first sentence.

²⁹¹ *Ibid.*, Article 5, paragraph 8, second and third sentences.

²⁹² *Ibid.*, Article 5, paragraph 2, first sentence. It is worth pointing out that monitoring of any bridge institution or asset management vehicle must also be considered as institution-specific conditions, provided that financial assistance is granted under the provisions laid down in Article 10, paragraph 2, point (c) therein, according to the above-mentioned (under 3.4.5 (b)(iii)) (*Ibid.*).

²⁹³ *Ibid.*, Article 5, paragraph 2, second sentence.

²⁹⁴ *Ibid.*, Article 5, paragraph 2, third sentence.

basis and upon request by the ESM decision-making bodies (on these bodies, *see* above, under A, 2.2).²⁹⁵

(b) Again, the institution-specific agreement must (wherever possible) contain appropriate contractual covenants related to non-compliance with the institution-specific conditions, including contractual financial sanctions.²⁹⁶ In case of non-compliance, the Board of Directors may, upon a proposal from the Managing Director of the ESM, enforce such covenants and, if deemed necessary, notify the ECB in its capacity as the single supervisory authority within the SSM of any violation of these conditions.²⁹⁷

3.4.7.4 Compliance with other policy conditions

(a) As a general rule, monitoring of all other policy conditions must be conducted by the European Commission, in liaison with the ECB, the ESM and (wherever appropriate) the IMF.²⁹⁸ Where deemed necessary, the monitoring institutions must also be authorised to involve other relevant experts, such as:

- external auditors, or
- monitoring trustees.²⁹⁹

Accordingly, the relevant institutions must provide details on the conditions monitored to the Board of Directors.³⁰⁰

(b) Nevertheless, an additional assessment by the IMF³⁰¹ of the implementation of international financial standards³⁰² and supervisory practices may (where appropriate) be actively sought by the beneficiary ESM Member, during the period of implementation of the financial assistance.³⁰³

²⁹⁵ *Ibid.*, Article 5, paragraph 2, fourth sentence.

²⁹⁶ *Ibid.*, Article 5, paragraph 8, first sentence.

²⁹⁷ *Ibid.*, Article 5, paragraph 8, second and third sentences.

²⁹⁸ *Ibid.*, Article 5, paragraph 3, first sentence.

²⁹⁹ *Ibid.*, Article 5, paragraph 3, second sentence.

³⁰⁰ *Ibid.*, Article 5, paragraph 3, third sentence.

³⁰¹ The IMF ensures the stability of the financial system of its Member States, in liaison with the World Bank, via the so-called ‘Financial Sector Assessment Programme’ (the ‘FSAP’). For a general overview of the key aspects of this programme, *see* indicatively **International Monetary Fund and World Bank (2003)** and **Gortsos (2012a)**, pp. 152-157.

³⁰² A standard is defined as a ‘model rule’ which often needs to be further specified due to its inherent vagueness. The specification of their content is made on an *ad hoc* basis, when there is resort to them. As such, they constitute international ‘soft law’, namely rules the key feature of which is that they lack any legally binding character. For more details on the legal nature of the international financial standards, as well as the making of those by the so-called ‘international fora’, *see* indicatively **Gortsos (2012a)**, pp. 138-139 and 160-195 respectively and **House of Lords (2015)**, pp. 66-73.

³⁰³ **Guideline on Financial Assistance for the DRI**, Article 5, paragraph 5.

3.5 Other provisions

3.5.1 Exit from the DRI

(a) Upon proposal from the Managing Director of the ESM, the Board of Directors may decide to sell the capital instruments acquired:

- in full, or
- in several tranches.³⁰⁴

Subject to the prior agreement of the Board of Directors, the recapitalisation may also be terminated by:

- the redemption, or
- the buy-back of the capital instruments by the recapitalised institution(s) concerned.³⁰⁵

Upon disposal or redemption of all capital instruments owned by the ESM, the financial assistance provided under the DRI must be deemed terminated.³⁰⁶

(b) The ESM Member concerned must be informed in advance on a confidential basis about the termination of the financial assistance provided under the DRI.³⁰⁷ Moreover, that ESM Member must not sell to a third party the capital instruments that it may have acquired, without the prior authorisation of the Board of Directors.³⁰⁸ This applies as long as the ESM still holds the capital instruments that it has acquired, during the implementation of the DRI.³⁰⁹

(c) The above-mentioned provisions are without prejudice to the application of the restructuring conditions set out in the Decision of the European Commission, in accordance with the provisions laid down in **Article 4, paragraph 11** of the relevant Guideline (on these provisions *see* above, under 3.3(I)(d)).³¹⁰ Thus, any changes that the ESM (or the ESM Member concerned) envisages to make to the restructuring conditions should be first notified and, subsequently, approved by the European Commission.³¹¹

3.5.2 Retroactive application of the DRI

(a) Without prejudice to the existing ESM and EFSF programmes, in which financial assistance has been provided towards ESM Members who recapitalised their institutions, the Board of Governors may decide on a case-by-case basis and by mutual agreement (on this procedure, *see* above, under A, 2.2.1.2(a)) the retroactive

³⁰⁴ *Ibid.*, Article 12, paragraph 1, first sentence.

³⁰⁵ *Ibid.*, Article 12, paragraph 3.

³⁰⁶ *Ibid.*, Article 12, paragraph 4.

³⁰⁷ *Ibid.*, Article 12, paragraph 1, second sentence.

³⁰⁸ *Ibid.*, Article 12, paragraph 2.

³⁰⁹ *Ibid.*

³¹⁰ *Ibid.*, Article 12, paragraph 5, first sentence.

³¹¹ *Ibid.*, Article 12, paragraph 5, second sentence.

application of the DRI.³¹² Such existing financial assistance may be replaced in part or in full.³¹³

(b) The detailed modalities for such replacement must be established in the relevant Decision taken by the Board of Governors.³¹⁴

3.5.3 Review

(a) At least every two (2) years after its entry into force, the Board of Directors must review the provisions of the relevant Guideline to assess whether:

- changes are required in light of developments related to the establishment of the EBU, and
- the rules related to the contribution of an ESM Member, in accordance with the provisions laid down in **Article 9, paragraph 1** therein, in accordance with the above-mentioned (under 3.4.4(a)), remain appropriate.³¹⁵

(b) In addition, a more comprehensive overview must take place ten (10) years after the entry into force of the relevant Guideline, at which point a Decision must be taken on the continuation of the DRI.³¹⁶

3.5.4 Information

The ESM must provide comprehensive information to its decision-making bodies (on these bodies, *see* above, under A, 2.2) regarding the DRI operations, including the reports referred to in **Article 5, paragraph 2** of the relevant Guideline (*see* above, under 3.4.7.3(a)).³¹⁷

³¹² *Ibid.*, Article 14, paragraph 1.

³¹³ *Ibid.*

³¹⁴ *Ibid.*, Article 14, paragraph 2.

³¹⁵ *Ibid.*, Article 15, paragraph 1.

³¹⁶ *Ibid.*, Article 15, paragraph 2.

³¹⁷ *Ibid.*, Article 16.

C. Concluding Remarks

1. An evaluation of the ESM

(a) The so-called ‘twin crises’ (the recent (2007-2009) international financial crisis³¹⁸ as well as the current (2010-?) fiscal crisis within the eurozone³¹⁹) have exposed major deficiencies in the design and implementation of the existing economic governance framework within the EU as a whole, and in the euro area in particular. The fiscal rules (laid down in certain provisions in the EU Treaties and further analysed within the context of the Stability and Growth Pact) have weakened over time, and procedures as well as measures put in place to enforce economic policy coordination have not been implemented.

(b) If these weaknesses and gaps were left unaddressed, the financial stability of the euro area as a whole could be put at detrimental risk. The EMU is characterised by a high degree of economic and financial integration among its Member States, which in normal times is beneficial to the EU as a whole. In times of financial distress, however, close financial integration means that unsustainable developments in one Member State can easily spread to others perceived as vulnerable by the financial markets, through the emergence of the so-called ‘spill-over effects’.

(c) Thus, the failure of the EU’s economic governance framework to prevent and correct unviable national policies that contributed to the build-up of major imbalances in euro area Member States has made the deficiencies of the overall governance framework all too apparent. This applies in particular to:

- the weak implementation of policy recommendations,
- the inadequacy of enforcement measures taken to discourage or correct infringements, and
- the inadequate recognition by national policy-makers of the need to ensure consistency between national policies within the EMU, especially with regard to competitiveness key aspects.³²⁰

(d) In order to overcome all the above-mentioned barriers:

- strict observance of the fiscal rules (laid down in certain provisions in the EU Treaties and further analysed within the context of the Stability and Growth Pact),
- close surveillance of macroeconomic imbalances, and
- effective economic policy coordination,

should provide an adequate ‘line of defense’³²¹ against crises of confidence of the type and magnitude that have been experienced in the recent years.³²²

³¹⁸ For a detailed analysis of the recent (2007-2009) international financial crisis, *see* indicatively **Krugman (2009)**, **Lastra and Wood (2010)**, pp. 531-550, **Sakbani (2013)**, pp. 97-101 and **Hadjiemmanuil (2015)**, pp. 4-6.

³¹⁹ For a detailed analysis of the current (2010-?) fiscal crisis within the eurozone, *see* indicatively **Hieronymi (2013)**, pp. 48-63, **Sakbani (2013)**, pp. 101-107 and **Hadjiemmanuil (2015)**, pp. 6-10. On the impact of this crisis on the Greek banking sector and the measures adopted to preserve its stability, *see* indicatively **Gortsos (2013b)**, pp. 164-188.

³²⁰ *See* on this (with further references) **European Central Bank (2011a)**, p. 72.

³²¹ The rationale behind this ‘line of defense’ is provided within the content of Recital 4 of the **ESM Treaty**, which states in this respect: ‘*Strict observance of the EU framework, the*

Nevertheless, to the extent that unforeseen external shocks may indeed occur, the risk of financial distress can never be fully eliminated, in spite of strengthened fiscal and macroeconomic surveillance. Hence, and in order to ensure the stability of the euro area as a whole, it was decided at the European Council meeting held concurrently on 16-17 December 2010³²³ to establish, alongside the two (2) temporary financial backstops³²⁴ – the EFSM and the EFSF – a permanent crisis resolution mechanism (the ‘ESM’), which could provide temporary ‘last resort lending’ to Member States comprising the euro area, with the aim of providing the necessary funding for the period of time needed to implement a rigorous macroeconomic adjustment programme to correct imbalances and gradually regain market access.³²⁵

(e) The purpose of the ESM, fully operational since 8 October 2012, is to mobilise funding and provide financial assistance under strict economic policy conditionality to its members, when they are threatened or experiencing severe financing problems. Thus, financial assistance will only be granted if the Member State in question implements a macroeconomic adjustment programme capable of redressing the situation at hand. In general, such an adjustment programme includes fiscal consolidation measures and structural reforms that address labour and product market rigidities, thereby improving the growth potential of the real economy.³²⁶

While such measures have some negative impact in the short term, their full positive effect unfolds over the medium term. In this context, the provided financial assistance serves as a ‘liquidity bridge’ until the Member State in question regains access to market financing. At the same time, financial assistance must be granted on a non-concessional basis to increase the incentive for the Member State in question to return to market financing as soon as possible, thereby limiting the implications of the so-called ‘moral hazard’³²⁷ phenomenon. In addition, any financial assistance must be disbursed in tranches, conditional on the Member State’s adherence to the targets described in the content of the relevant macroeconomic adjustment programme, so as to maintain the incentive for that country to continue to fully comply with it.³²⁸

integrated macroeconomic surveillance, in particular the Stability and Growth Pact, the macroeconomic imbalances framework and the economic governance rules of the EU, should remain the first line of defense against confidence crises affecting the stability of the euro area’.

³²² For a general overview of the key elements on the reform of the economic governance framework within the euro area, *see* indicatively **European Central Bank (2011c)**, pp. 99-119, **European Central Bank (2012)**, pp. 79-94, **European Central Bank (2013)**, pp. 53-55, **Lastra (2013)**, pp. 35-71, **Stephanou (2013)**, pp. 143-151 and **Alcidi, Giovannini and Piedrafita (2014)**, pp. 19-40.

³²³ **European Council Conclusions, 16-17 December 2010**, EUCO 30/1/10 REV 1, paragraph 1, available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/118578.pdf

³²⁴ On the political and economic (medium-run and long-term) rationale of establishing financial backstops within the eurozone, *see* **Belke (2010)**, **De Grauwe (2011)** and **Sturm (2011)**.

³²⁵ The creation of the euro area crisis management framework has been motivated by three (3) main considerations. *See* on these **European Central Bank (2011a)**, pp. 73-74.

³²⁶ It is worth pointing out, however, that economic policy alternatives and the relevant Decisions are not straightforward, when they need to be implemented within a severe economic crisis, a typical example being the case of Greece since 2008. *See* on this **Haritakis (2013)**, pp. 189-210.

³²⁷ On the close correlation between the bail-out mechanisms and the moral hazard issue, *see* indicatively **Dowd (2009)**, **Lane and Phillips (2000)** and **Stephanou (2013)**, p. 141.

³²⁸ These observations are further analysed in **European Central Bank (2011a)**, pp. 72-73.

As of March 2015, the ESM has provided financial assistance to Spain³²⁹ for the recapitalisation of its banking sector, and is providing financial assistance to Cyprus³³⁰ to cover its financing needs, which include (inter alia):

- *budgetary financing,*
- *the redemption of medium and long-term debt, and*
- *the recapitalisation of its credit institutions except the country's two (2) largest ones (i.e. Bank of Cyprus and Cyprus Popular Bank), which were subject to restructuring and resolution measures taken by the Cypriot government.*

(f) However, in the author's view a critical issue, which may constitute an insurmountable barrier on the ESM future funding activities is the limited volume of its effective lending capacity (i.e. 500 billion euros), if asked to provide financial assistance in cases where the magnitude of the relevant economies of scale of euro area Member States is considered too high.³³¹ Therefore, in order to address the above-mentioned issue, the (financial and technical) contribution of the IMF is expected to (continue to) be of utmost importance, in accordance with the above-mentioned (under A, 3.5), while at the same time one cannot exclude the possibility of an increase of its maximum lending volume, through an adoption of a formal Decision taken by the ESM Board of Governors, as mentioned above (under A, 1(e)).

³²⁹ See on this at: <http://www.esm.europa.eu/assistance/spain/index.htm>

³³⁰ See on this at: <http://www.esm.europa.eu/assistance/cyprus/index.htm>

³³¹ The case of a 'fully-fledged' macroeconomic adjustment programme of Italy and the total bail-out of Spain are the most notable examples.

2. An evaluation of the DRI

(a) As part of its ‘twin crises’ response strategy, the EU has undertaken a wide set of measures in the financial sector that, *inter alia*, focus on the establishment a ‘European Banking Union’ consisting of:

- a Single Supervisory Mechanism exclusively for the banking sector and mainly for credit institutions legally incorporated in euro area Member States,
- a Single Resolution Mechanism for insolvent credit institutions and a Single Resolution Fund, financed by the banking industry, to cover any resulting funding gaps, provided that a decision is made on the resolution of such credit institutions,
- a Single Deposit Guarantee Scheme, which coupled with the Single Resolution Board (a part of the Single Resolution Mechanism) could form a ‘European Deposit Insurance and Resolution Authority’, or ‘EDIRA’, and
- a ‘Single Rulebook’³³² containing substantive rules on all the previous aspects, aiming at a ‘total harmonisation approach’, as part of the single market for financial services, applicable across EU Member States.³³³

The bold Decision leading to the creation of a ‘European Banking Union’ was taken during the Euro Area Summit of 28-29 June 2012; the main rationale behind it was the imperative need to break the vicious loop between banks and sovereigns.

(b) The ESM has a vital role within the context of the EBU, since it was created as a crisis resolution mechanism for euro area Member States. Apart from macroeconomic adjustment programmes and loans to its Member States, the ESM also has the capacity to deal with issues pertaining to the financial sector of its Member States. Under the regime in place until 8 December 2014, the ESM could provide financial assistance towards its Members for the specific purpose of recapitalising credit institutions only *indirectly* under the following terms:

- a loan was provided by the ESM to the Government of the requesting euro area Member State under a ‘Financial Institution Recapitalisation Facility’, and
- the funds were earmarked for the recapitalisation of one or more ailing credit institutions.

However, such assistance increases the beneficiary Member State’s public debt, which could have a negative impact on market sentiment.³³⁴

(c) The prospect of *direct* recapitalisation of credit institutions incorporated in euro area Member States through the ESM was (for the first time in an explicit way) mentioned during the Euro Area Summit meeting, which was held concurrently on 28-29 June 2012. After a series of tentative negotiations and discussions held between the euro area Member States, the ESM Board of Governors adopted, on 8 December 2014, the DRI, thereby granting the ESM the right to conduct *direct* investment in equity of ailing financial institutions, incorporated into euro area Member States.

³³² The European Banking Authority (known as the ‘EBA’) plays a key role in building up of the Single Rulebook in the field of the EU banking sector. For a comprehensive overview of this Authority, *see* indicatively **Gortsos (2011b)**.

³³³ For a comprehensive overview of the legal framework of the EBU, *see* **Gortsos (2015)**, pp. 39-75.

³³⁴ The most notable examples were the cases of *indirect* bank recapitalisation provided to Spain and Cyprus. For more details, *see* **Eurostat (2012)**, **European Stability Mechanism (2013)**, pp. 21 and 17, respectively and **Eurostat (2014)**.

(d) Thus, the DRI allows the ESM to recapitalise a systemically important and viable euro area financial institution *directly*, under specific circumstances and always as a last resort measure. In order to preserve the ESM's high creditworthiness (the so-called 'Triple A' rating) and effective lending capacity for other financial instruments, the total amount of ESM resources available for the DRI is limited to 60 billion euros.³³⁵

(e) However, as a necessary precondition for the use of the DRI, the bail-in of private investors (in accordance with the relevant provisions of the **BRRD**) and the contribution of a national resolution fund (for a transitional period until December 2015) or the SRF (from January 2016 onwards) has shifted the bulk of potential financing from the ESM to the financial institutions themselves, along with their investors and creditors.

Hence, the DRI will only be applied when:

- all 'burden-sharing arrangements' specified in the relevant Guideline, in accordance with the above-mentioned (under B, 3.4.3), prove insufficient to restore the financial institution's viability,
- the eligibility criteria regarding the requesting ESM Member and the institution requiring recapitalisation are met, according to the above-mentioned (under B, 3.2(III)), and
- financial assistance through the *indirect* recapitalisation instrument is not feasible.³³⁶

(f) In conclusion, it is evident that the DRI will not be applied, at least in the foreseeable future.³³⁷ Nevertheless, the ESM is ready to make use of it, should the need arise. The Managing Director of the ESM was firm on this:

*'The ESM is ready to use the DRI, should the need arise. The results of the recent asset quality review and stress tests confirm that the use of the new instrument seems unlikely. Nevertheless, the fact that the ESM can provide a rescue of last resort for systemic and viable banks is reassuring for markets and safeguards financial stability in the euro area.'*³³⁸

³³⁵ On the rationale of setting a maximum limit on the amount of resources available for use under the DRI, *see* in particular point 16 in **European Stability Mechanism (2014a)**.

³³⁶ On the rationale of the application as well as the significance of the DRI, *see* in particular point 3 (*Ibid*).

³³⁷ With regard to the potential use of the DRI, the author fully subscribes to the comment made in **Hadjiemmanuil (2015)**, p. 34: '(...) *in view of its very strict preconditions and terms (not least, the need for unanimity in the ESM's Board of Governors for its activation), the DRI is unlikely to be used in other than wholly exceptional circumstances. (...) It is thus relegated almost to a footnote in the Banking Union's overall design. (...)*'

³³⁸ *See* on this at: <http://www.esm.europa.eu/press/releases/esm-direct-bank-recapitalisation-instrument-adopted.htm>

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B. EU Law

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Protocol (No 4) TEU and TFEU ‘on the Statute of the European System of Central Banks and of the European Central Bank’ (OJ C 326, 26.10.2012, pp. 230-250)

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2. Regulations (in chronological order)

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Council Regulation (EU) No 1024/2013 of 15 October 2013 ‘*conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions*’ (OJ L 287, 29.10.2013, pp. 63-89)

Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 ‘*on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012*’ (OJ L 176, 27.6.2013, pp. 1-337)

Regulation (EU) No 473/2013 of the European Parliament and of the Council of 21 May 2013 ‘*on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area*’ (OJ L 140, 27.5.2013, pp. 11-23)

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3. Directives (in chronological order)

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4. Other (in chronological order)

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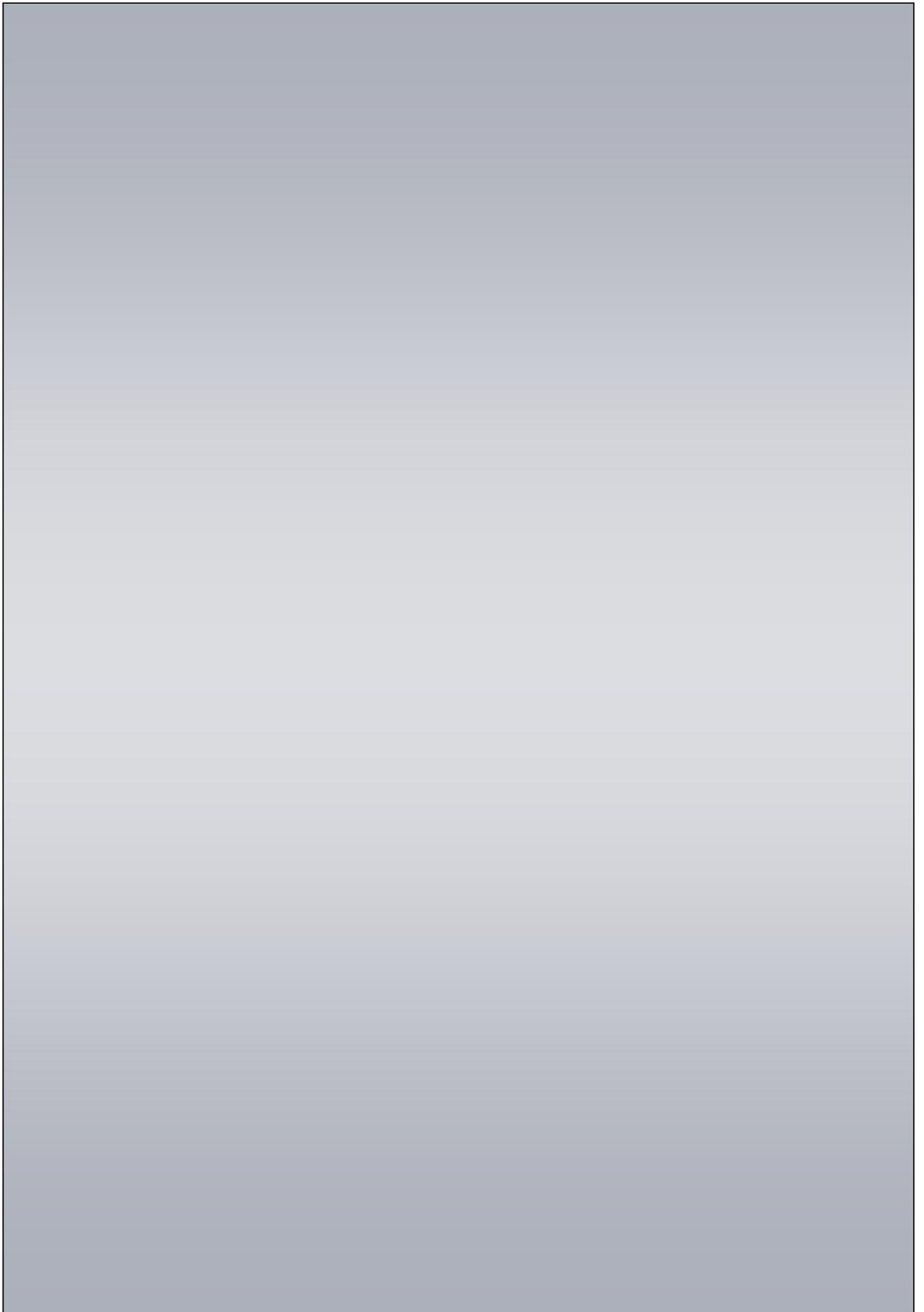
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