

## EUROPEAN STABILITY MECHANISM INVESTMENT GUIDELINES

### *Preface*

According to Article 22 of the Treaty establishing the European Stability Mechanism (the “ESM Treaty”) the Managing Director shall implement a prudent investment policy for the ESM in accordance with guidelines to be adopted and reviewed by the Board of Directors. The following investment guidelines (the “Investment Guidelines”) set out the framework for that prudent investment policy aimed at ensuring the high creditworthiness for the ESM, the liquidity of investments, and the constant availability of the ESM’s lending capacity, while also maximising the ability to absorb potential losses.

These Investment Guidelines apply to the investment activities for the ESM’s paid-in capital and reserve fund (the “Investment Portfolios”). Additionally, Article 5 of these Investment Guidelines governs the investment of the proceeds of ESM pre-funding activities.

Finally, these Investment Guidelines also foresee the creation of additional operational portfolios by decision of the Board of Directors, following a proposal by the Managing Director. This is without prejudice to the creation of other funds established by the ESM Board of Governors pursuant to Article 24(1) of the ESM Treaty, or to the emergency reserve fund pursuant to Article 4(4) of the ESM Treaty, for which guidelines will be approved at the time of their creation.

### *Article 1*

#### *Investment objectives*

The Investment Portfolios shall be invested with the following objectives:

1. ***Liquidity of Investment Portfolios*** - The Investment Portfolios shall be used in line with Article 25 of the ESM Treaty to cover losses arising from ESM operations, and specifically any shortfall due to a non-payment by an ESM member state benefitting from financial assistance. When the emergency procedure referred to in Article 4(4) of the ESM Treaty is used, a transfer from the reserve fund and/or the paid-in capital to an emergency reserve fund is made in order to constitute a dedicated buffer to cover the risks arising from the financial support granted under that emergency procedure.
2. ***Constant availability of ESM’s maximum lending volume*** - The risk appetite for the investment of the Investment Portfolios shall be defined in accordance with the ESM High Level Principles for Risk Management. The ESM investment policy must ensure that the market value of the Investment Portfolios is at least 15% of the targeted maximum lending volume of the ESM for a high level of confidence. An appropriate diversification of investments shall be used to reduce the volatility of the aggregate market value of the portfolio.
3. ***ESM’s creditworthiness*** - Pursuant to Article 22 of the ESM Treaty, the investment activity shall be conducted in accordance with a prudent investment policy, in order to preserve the highest creditworthiness for the ESM. To achieve this, a minimum amount equivalent to 15% of the targeted maximum lending volume of ESM at the time shall be invested in assets of the highest creditworthiness, as defined in the ‘General Eligible Asset List’ (Annex 1). The remaining part of the

Investment Portfolios shall be invested along the `Enlarged Eligible Asset List` (Annex 2), provided that the overall ESM exposure to each issuer has been taken into account in order to avoid concentration risk.

4. **Return** - Without prejudice to priority being given to the objectives set out in the previous paragraphs, the ESM's investment policy will also aim at achieving investment return on the Investment Portfolios, comparable to a benchmark portfolio constructed with similar objectives and constraints. In line with Article 22 of the ESM Treaty, the ESM shall be entitled to use part of the return on the Investment Portfolios to cover its operating and administrative costs. In line with Article 23 of the ESM Treaty and the dividend policy, investment return can be retained as reserves or distributed as a dividend to the ESM Members "*where the amount of paid-in capital and the reserve fund exceed the level required for the ESM to maintain its lending capacity and where proceeds from the investment are not required to avoid a payment shortfall to creditors*".

## **Article 2**

### **Investment principles**

1. All transactions related to the Investment Portfolios shall be conducted in a prudent manner in order to ensure the highest creditworthiness of the ESM, as well as to limit any effects on market prices, including in situations of market stress.
2. All transactions related to the Investment Portfolios shall be conducted with eligible counterparties.
3. An appropriate level of diversification in the Investment Portfolios shall be maintained in order to reduce the volatility of the aggregate portfolio market value. Diversification shall be attained through allocation across various asset classes, geographical areas (notably, supranational institutions and issuers outside of the euro area), issuers and instruments.
4. Derivatives shall be used for risk management purposes only, the ESM being able to post its assets as collateral to the counterparties in such transactions within a prudent risk framework. Credit risk exposure in the context of derivatives transactions must be collateralised by cash or by debt securities eligible under Annex 1 (except for credit risk exposure to entities that are eligible issuers under Annex 1).
5. Currency risk shall be hedged into euro to ensure a limited remaining foreign exchange risk for the ESM. All else being equal, assets, issued by euro area or non-euro area entities, denominated in euro shall however be favoured over assets denominated in a foreign currency.
6. The implementation of these Investment Guidelines shall be governed by an appropriate governance framework to ensure the fulfilment of the investment objectives, and to allow the Board of Directors to monitor the management of the Investment Portfolios.

## **Article 3**

### **Eligible Instruments**

1. Within a prudent credit risk framework, the assets eligible under the investment policy for the ESM Investment Portfolios shall be selected based on the following two sets of eligibility criteria, depending on the nature of the investment objectives:

- a. Ability of the ESM to cover losses arising in the ESM operations, and maintain the constant availability of the targeted maximum lending volume and the highest financial strength of the ESM: 'General Eligible Assets List' (Annex 1);
  - b. Enhancement of diversification and return: 'Enlarged Eligible Assets List' (Annex 2).
2. In case any asset loses its eligibility under these Investment Guidelines, the Managing Director, in accordance with the Board of Directors, may decide to reduce the exposure to this given asset, but to do so within an appropriate timeframe and manner in order to minimise any impact on market prices.
3. The ESM may enter into repurchase and reverse repurchase agreements and shall be able to post its assets as collateral in this context.
4. In the context of repurchase agreements, the ESM may use assets:
  - a. from the Investment Portfolios:
    - i. in order to raise liquidity if, in accordance with the ESM High Level Principles for Risk Management, it is necessary to meet due payments to ESM creditors and to avoid or limit a capital call under Article 9(3) of the ESM Treaty;
    - ii. as part of its regular investment activities, in compliance with these Investment Guidelines and within a prudent risk framework;
  - b. from the Liquidity Buffer (as defined in Article 5), in order to raise liquidity to meet cash outflows related to ESM payment obligations.

#### **Article 4**

##### **Portfolio Structure**

1. For diversification purposes, at least 30% of the assets in the Investment Portfolios (excluding cash in current accounts with the Eurosystem) shall be invested either in supranational institutions or outside the euro area, and no sovereign exposure to an ESM member state shall represent more than its capital key as defined in the ESM Treaty.
2. The ESM investment objectives defined in Article 1 shall be implemented by dividing the Investment Portfolios into separate tranches. The characteristics and relative size of each tranche are described below.
3. The tranche with the highest requirements on the liquidity of its investments is the **Short-term tranche**:
  - a. The main objective of the Short-term tranche is to allow the ESM to face any temporary disbursement to cover any liquidity shortfall, *inter alia* due to a non-payment by an ESM member state benefitting from financial assistance.
  - b. The target size of this tranche shall be determined in line with the future payments due from ESM member states benefitting from financial assistance over at least the next 6 months, with a minimum overall size of EUR 5,000,000,000.
  - c. This tranche is invested in liquid instruments with a capital preservation objective at a one-year horizon, for a high level of confidence, to the extent possible in light of prevailing market conditions. Such prevailing market conditions shall be reported to, and acknowledged by, the Board Risk Committee, and shall be reported to the Board of Directors.
  - d. Assets of the Short-term tranche shall be compliant with the eligibility criteria set out in the General Eligible Assets List.

- e. The assets of reserve fund shall be invested in full in the Short-term tranche, and shall be included when determining the size of the Short-term tranche, namely under paragraph b.
4. The tranche to ensure diversification and financial strength is the **Medium/Long-term tranche**:
- a. The main objective of the Medium/Long-term tranche is to ensure the financial strength of the ESM. This tranche shall be managed to enhance the return on the Investment Portfolios, subject to the investment objectives set out in Article 1, as well as to the asset eligibility criteria applicable under these Investment Guidelines. This tranche is also mainly invested in liquid instruments, and may also be monetized.
  - b. The size of the Medium/Long-term tranche is the amount of the Investment Portfolios remaining after the constitution of the Short-term tranche and the Hold-to-maturity tranche foreseen below.
  - c. In order to meet the objective set out in Article 1(2) in relation to the minimum value of the Investment Portfolios, the Medium/Long-term tranche shall be invested with a capital preservation objective for a three-year horizon, and a maximum loss of 2% for a one-year horizon (for a high level of confidence), to the extent possible in light of prevailing market conditions. Such prevailing market conditions shall be reported to, and acknowledged by, the Board Risk Committee, and shall be reported to the Board of Directors.
  - d. In order to meet the objective set out in Article 1(3) in relation to the creditworthiness of the ESM, a minimum share of the Medium/Long term tranche shall be compliant with the eligibility criteria set out in the General Eligible Assets List. As defined in Article 1(3), this minimum share shall be such that an amount of the Investment Portfolios equivalent to 15% of the targeted maximum lending volume at the time is invested in the General Eligible Asset List. The amount of the Medium/Long term tranche exceeding that which is needed to meet this 15% threshold may be invested in assets eligible under the Enlarged Eligible Assets List.
5. The tranche to further promote long-term financial strength is the **Hold-to-maturity tranche**:
- a. The main objective of the Hold-to-maturity tranche is to reinforce the long-term financial strength of the ESM. This tranche shall be invested to enhance the return of the Investment Portfolios, subject to the other investment objectives foreseen in Article 1, as well as to comply, as of the time of purchase, with the eligibility criteria set out in the General Eligible Assets List.
  - b. The assets in the Hold-to-maturity tranche are intended to be held to maturity, and may be monetised only:
    - i. in order to raise liquidity if, in accordance with the ESM High Level Principles for Risk Management, it is necessary to meet due payments to ESM creditors and to avoid or limit a capital call under Article 9(3) of the ESM Treaty; or
    - ii. outside of the situation referred in i. above, to post collateral for derivatives used for risk management purposes in the Investment Portfolios.
  - c. Assets acquired for the Hold-to-maturity tranche that cease to be eligible under the General Eligible Assets List after their purchase, yet remain eligible under the Enlarged Eligible Assets List, may still be part of the Hold-to-maturity tranche, but must otherwise be treated in accordance with their new eligibility status, including for the purposes of Articles 1(3) and

5(2). For the avoidance of doubt, Article 3(2) applies if an asset in the Hold-to-maturity tranche loses eligibility under the Enlarged Eligible Assets List.

6. The Managing Director periodically determines the appropriate size of the Short-term tranche, the Medium/Long term tranche, and the Hold-to-maturity tranche in accordance with these Guidelines.

#### **Article 5**

##### **Management of the liquidity of ESM balance sheet**

1. On any date, if there is a shortfall between the Available Funds and the payments arising from ESM liabilities becoming due over the subsequent 12 months, such shortfall shall be prefunded. The prefunding of these needs shall be invested in a specific portfolio, referred to as the “Liquidity Buffer”.
2. For the purposes of this Article, “Available Funds” shall mean the aggregate of the Short-term tranche plus 50% of the assets complying with the eligibility criteria defined in the General Eligible Assets List that form part of the Medium/Long term tranche or of the Hold-to-maturity tranche. All assets posted as collateral as of the relevant date shall not contribute to the Available Funds.
3. The main investment objective for the Liquidity Buffer is to ensure sufficient liquidity is available to meet payments to ESM creditors as they come due, as well as disbursements to member states benefitting from financial support. Its assets are invested in liquid instruments with a capital preservation objective for a one-year horizon, for a high level of confidence, to the extent possible in light of prevailing market conditions. Such prevailing market conditions shall be reported to, and acknowledged by, the Board Risk Committee, and shall be reported to the Board of Directors. All investments relating to the Liquidity Buffer shall be made in accordance with the principles set out in Article 2 and shall comply with the eligibility criteria set out in the General Eligible Asset List.

#### **Article 6**

##### **Implementation**

1. Pursuant to his/her role under Article 22 of the ESM Treaty, the Managing Director is responsible for:
  - a. Organising periodic reviews of these Investment Guidelines by the Board of Directors;
  - b. Defining an appropriate governance framework for the implementation of the ESM investment policy, including the composition and operation of any relevant internal committees and the content of any internal documentation (to the extent that such content is not in conflict with these Investment Guidelines);
  - c. Presiding over the implementation of the ESM investment policy in accordance with these Investment Guidelines and the risk framework, based on relevant risk indicators and benchmarks, and report on that implementation to the Board of Directors.
2. The Managing Director shall ensure a smooth implementation of the Investment Guidelines. In cases where the investment of capital payments along the targeted investment policy might lead to market price impacts, some temporary divergence, namely a higher share in short term and very liquid assets, shall be tolerated. During the periods referred in Article 3(4)(a)(i) above, when, in accordance with ESM High Level Principles for Risk Management, the Investment Portfolios may provide liquidity if necessary to meet due payments to ESM’s creditors and to avoid or reduce a capital call under Article 9(3) of the

ESM Treaty, any resulting divergence shall be corrected within an appropriate timeframe and manner in order to minimise any impact on market prices, and shall be reported to the Board of Directors.

**Article 7**  
**Operational Portfolios**

The Board of Directors may, following a proposal from the Managing Director, approve the creation of portfolios in addition to (and independent from) those set out in these Guidelines (the “Operational Portfolios”). The investment policy for each Operational Portfolio will be established by the Managing Director, subject to guidelines approved by the Board of Directors pursuant to Article 22 of the ESM Treaty.

## Annex 1

### General Eligible Assets List

Assets eligible for the General Eligible Assets List are:

- **The instruments, listed below:**
  - o Debt securities (including bonds, bills, covered bonds, commercial paper, and certificates of deposit),
  - o Secured money market transactions (including Reverse repurchase agreements), where the securities received are themselves eligible for investment under this Annex,
  - o Unsecured money market transactions.
- **Issued by any of the following entities, or contracted with any of the following entities:**
  - o Central banks,
  - o Sovereigns and their related debt management offices,
  - o Government-related agencies,
  - o Supranational institutions,
  - o Sub-sovereign entities,
  - o Government-guaranteed issuers,
  - o Financial institutions.
- **And respecting the following rating criteria:**
  - o Minimum rating for credit exposure (debt securities and unsecured transactions) on all entities, except central banks and financial institutions:

For eligible rating agencies, a short-term or long-term rating (as applicable) which is equal to or higher than AA- (or equivalent for short-term assets).
  - o Minimum rating for credit exposure (debt securities and unsecured transactions) on financial institutions:

For eligible rating agencies, a short-term or long-term rating (as applicable) which is equal to AAA (or equivalent for short-term assets).

## Annex 2

### Enlarged Eligible Assets List

Assets eligible for the Enlarged Eligible Assets List are:

- **The Instruments, listed below:**
  - o Debt securities (including bonds, bills, covered bonds, commercial paper, and certificates of deposit),
  - o Secured money market transactions (including Reverse repurchase agreements), where the securities received are themselves eligible for investment under this Annex,
  - o Unsecured money market transactions.
- **Issued by any of the following entities, or contracted with any of the following entities:**
  - o Central banks,
  - o Sovereigns and their related debt management offices,
  - o Government-related agencies,
  - o Supranational institutions,
  - o Sub-sovereign entities,
  - o Government-guaranteed issuers,
  - o Financial institutions.
- **And respecting the following rating criteria:**
  - o Minimum rating for credit exposure (debt securities and unsecured transactions) on financial institutions:

For eligible rating agencies, a short-term or long-term rating (as applicable) which is equal to or higher than AA (or equivalent for short-term assets).
  - o Minimum rating for credit exposure (debt securities and unsecured transactions) on all entities, except central banks, financial institutions and euro area sovereigns:

For eligible rating agencies, a short-term or long-term rating (as applicable) which is equal to or higher than A (or equivalent for short-term assets).