

INVESTOR CONFERENCE CALL
EUROPEAN STABILITY MECHANISM
TUESDAY 25TH SEPTEMBER
11AM

Introduction by Klaus Regling

First I'd like to say that this is a good moment for our call. A number of important things happened during the last few weeks. Let me mention the positive decision by the German Constitutional Court on 12 September with regard to the ESM and the fiscal compact. This was one of the final steps required to complete the ratification process of the ESM Treaty.

The imminent inauguration of the ESM is an important milestone and gives another strong signal of the commitment of the 17 euro area Member States to resolve the crisis and to build a stronger framework for the euro zone for the future.

Also, the decision by the ECB on 6 September to undertake Outright Monetary Transactions (OMTs) under certain conditions is another significant step to safeguard stability in the euro area. With the ECB and the EFSF/ESM working in parallel, this can provide an effective tool to reduce lending costs for euro area Member States.

The European Stability Mechanism will be a permanent crisis resolution mechanism. It will be an intergovernmental organisation under public international law. The ESM shareholders will be the 17 euro area Member States and it will have a subscribed capital of €700 billion comprising €80 billion in paid-in capital and €620 billion in committed callable capital.

Like the EFSF, its mandate will be to safeguard financial stability in the euro zone by providing financial assistance to euro area Member States.

ESM will be authorised to use the following instruments linked to appropriate conditionality:

- Provide loans to countries in financial difficulties
- Intervene in the primary and secondary debt markets.
- Act on the basis of a precautionary programme
- Finance recapitalisation of financial institutions through loans to governments

To fulfil its mission, ESM will issue bonds and other debt instruments.

The success of the EFSF in raising funds and providing cheap financing to countries under a programme and the progress made by Ireland and Portugal demonstrate that this strategy is working.

We hope to continue this success with the ESM.

INTRODUCTION

1. *When will the ESM be operational?*

KR: ESM is expected to be inaugurated on 8th October. The ESM will be fully operational, i.e. ready to finance new support programmes shortly thereafter. It will take a short time to finalise the last legal steps that cannot be completed until the institution exists, e.g. registration with the stock exchange. Due to the fact that the existing EFSF staff will also work for the ESM, a smooth transition will be ensured between the two institutions. We currently have over 60 members of staff.

2. *What is the remaining lending capacity of the ESM? Is it EUR 400bn if we take into account the EUR 100bn earmarked for Spain?*

KR: Yes, this is correct but the exact amount will only be known after the results of the bottom-up audit of Spanish banks are published later this week. We will then know if the full EUR 100 billion is needed, which is unlikely. Consequently, I expect the remaining lending capacity to be higher than €400 billion.

Apart from the ESM, the EFSF will continue to support the existing programmes for Ireland, Portugal and Greece.

3. *The subscribed capital is EUR700bn; why has the support volume only be set to EUR500bn?*

KR: The €700 billion in subscribed capital of ESM comprises paid-in capital of €80 billion and committed callable capital of €620 billion. This gives the ESM a robust capital structure. The credit enhancement structure with the over-guarantee which is used by the EFSF will no longer be required for the ESM.

In order to provide additional assurance to investors and to obtain a top rating, the maximum lending volume was set at EUR 500 billion. This means that the subscribed capital exceeds the maximum lending volume by 40%.

4. *When will the first and second tranche of the ESM capital be paid in?*

KR: The capital will be paid in 5 instalments of €16 billion each. The first two instalments will be paid in October within 15 days of entry into force of the ESM. The next two instalments are scheduled for 2013, and the final one in the first half of 2014.

5. *Regarding the capitalization structure: what happens if a country cannot meet capital calls?*

KR: This is a key question for our investors; let me therefore give a somewhat longer and detailed answer.

There are three different instances when a capital call can be made:

- 1) General capital calls
- 2) Capital calls to replenish paid-in capital

3) Emergency capital calls

- 1) A general capital call concerns payment of the initial capital and also, if necessary, an increase of paid-in capital which could be necessary, for example, to raise the lending capacity. To initiate such a call, the Managing Director of the ESM, would make a proposal to the Board of Governors outlining the objective of such a call, the amounts and contributions for each shareholder and a proposed payment schedule. The Board of Governors, with mutual agreement, may call in authorized capital at any time.
- 2) A capital call to replenish paid-in capital could happen for two reasons: a) to cover any losses in paid-in capital due to a non-payment by a beneficiary country and b) in order to maintain a minimum 15% ratio between paid-in capital and the lending capacity of ESM. The Managing Director would again make a proposal, this time to the Board of Directors, which would specify the losses incurred and the underlying reasons. Simple majority of the Board of Directors is required to agree to call in capital under these circumstances.

If any ESM member fails to meet the required capital call, one or more revised increased capital calls would be made to all ESM Members by increasing the contribution rate of the remaining ESM Members on a pro-rata basis. When the ESM Member which failed to contribute settles its debt to the ESM, the excess capital is returned to the other ESM Members.

- 3) Finally, an emergency capital call would be used for the acceleration of the paid-in capital during the ramp-up period to comply with the requested capital ratio and to avoid default of an ESM payment obligation to its creditors. The Managing Director would have the responsibility to make such a capital call to ESM shareholders if there were such a risk of default. As stated in the ESM treaty, the ESM shareholders have irrevocably and unconditionally undertaken to pay on demand such a capital within 7 days of receipt of the demand. However, if any ESM Member fails to meet the required capital call, the same procedure would apply as for capital calls to replenish paid-in capital. This mechanism works effectively like a guarantee and provides the strongest possible assurance to ESM bondholders that they will always be serviced and repaid.

6. *Does the ruling of the German constitutional court have an effect on the way the capital calls work?*

KR: No, following on what I outlined in the previous answer, the ruling of the German Constitutional Court does not change anything for Germany with respect to capital calls. All Member States share this interpretation of the Court's ruling.

The particular payment obligations of each future ESM member resulting from the capital calls mentioned above are limited to the amounts stipulated in Annex II to the Treaty. In the case of Germany, for instance, any liability is capped at EUR 190 024 800 000.

7. *When will the ESM guidelines on primary and secondary market purchases be published? Should we expect them to be similar to the EFSF ones?*

KR: The ESM guidelines are expected to be published on the ESM website following the inauguration of the ESM. The ESM guidelines will broadly resemble the EFSF guidelines.

8. *What is the likely rating of ESM obligations? Are you already in contact with rating agencies?*

KR: We have applied for ratings for the ESM and we are currently in discussions with the rating agencies.

9. *If a new country asks for assistance in the primary and/or secondary markets, and if the ESM is not fully ready yet (e.g. because hasn't raised a sufficient amount of cash in the market to operate efficiently yet), and the EFSF starts providing such assistance, will this assistance be ultimately transferred to the ESM when the latter is finally ready, like for the recapitalisation of Spanish banks?*

KR: It is expected that the ESM will be ready very soon to provide assistance to new countries which may ask for such assistance. In the very unlikely event that emergency funding would be required before ESM is fully operational, EFSF would be there as a backstop. The assistance would subsequently be transferred from EFSF to ESM.

10. *Do you intend to ask for a banking license for the ESM?*

KR: No. The ECB published an analysis last year according to which the ECB is not allowed for legal reasons to grant the ESM a banking license, which holds similar for the EFSF. In addition, requesting access to ECB liquidity would require mutual agreement of all of the ESM shareholders.

The question of a banking license is often over-interpreted in my view. It would make the funding side easier, of course, but would not allow unlimited lending by the EFSF or ESM.

11. *Will the ESM retain its seniority status if it provides assistance in the secondary and/or primary market? For instance, should it provide this kind of assistance to Spain, would the ESM renege its seniority status, or would it intend to keep it?*

KR: It is a mutual understanding of ESM members that ESM loans and other forms of financial assistance 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. The decision to forego preferred creditor status in the case of Spanish bank recap was one-off in nature, as the FFA was negotiated by the EFSF. This FFA will be transferred to the ESM with all rights and obligations, including the EFSF's *pari passu* status.

12. *Can the ESM Treaty still be changed?*

KR: Any Treaty can be amended if all the signatory countries agree to do so. Our Member States have different national procedures to do so in the case of the ESM Treaty and in several of the Member States, this would require the involvement of the national parliament in line with their ratification procedures

13. Can the discussed changes to the seniority status and the direct bank recapitalisation of the ESM be decided without a new ratification of the ESM treaty?

KR: Seniority for ESM loans is a mutual understanding between ESM members and is mentioned in recital (13) of the ESM treaty. Reference is made to the decision of Heads of State and Government in that regard. A repeal or amendment of their earlier statement would therefore also require a decision by the Heads of State or Government. In several Member States it would require support by the national parliament.

With regards to direct bank recapitalisation, it is our opinion (based on Article 19 of the Treaty) that it would be possible without a treaty change, by a unanimous decision of the Board of Governors. We know that the Governors would not do this without support from their parliaments. Some lawyers even argue that a treaty change would be required.

14. Will the ESM be able to participate in the repo market to finance bond purchases?

CF: No, with regard to ECB's repo market. Yes, with private banks or other market participants.

15. Will the ESM be able to use the paid in capital to purchase sovereign bonds in the market?

CF: The paid-in capital will be invested in high quality liquid assets and in accordance with ESM investment guidelines. It will serve as loss absorbing capital only. Thus the paid-in capital will not be used to purchase sovereign bonds under an ESM primary or secondary market intervention, but it could be used to purchase top-rated and liquid sovereign bonds for investment purposes.

EFSF AND ESM WORKING TOGETHER

16. Will the EFSF and the ESM be merged?

KR: The EFSF is a company established under Luxembourg law whereas the ESM is an intergovernmental institution established under international law. As legal entities with such different structures, the two institutions will not be merged.

However, as already mentioned the current staff of the EFSF will also work for the ESM. This will ensure that the ESM will be fully operational in October. It will also allow the ESM to benefit from the experience gained by the EFSF staff. Over the last two years, EFSF has become a well-established issuer in the sovereign debt market. We fully expect to continue this success with the ESM.

17. What happens to the EFSF once the ESM is in place?

CF: The ESM will be the main instrument to finance new programmes. The EFSF will only remain active in financing programmes that started before the ESM became operational. However, for a transitional period until 30 June 2013, the EFSF may engage in new programmes in order to

ensure a full fresh lending capacity of €500 billion. In any case, EFSF will complete the existing programmes for Ireland, Portugal and Greece. Once these programmes have been completed, the EFSF will continue functioning in an administrative capacity until all outstanding loans and bonds have been repaid.

18. Will the EFSF continue to issue bonds under the existing programmes for Ireland, Portugal and Greece? Will the EFSF adjust its funding target once the ESM is operational?

CF: As just mentioned, the EFSF will finance the programmes that started before the ESM became operational. It will therefore continue to issue bonds to fund the programmes for Ireland, Portugal and Greece. As the funding activity remains the same, no adjustments to its funding targets are necessary.

19. Assuming that one of these countries needs further support than the scheduled €192bn, does this mean that the EFSF could also issue more bonds after 2014 (when the program for Greece is supposed to end)? Or will the ESM take care of that additional financing? However, this would still leave the combined EFSF/ESM lending volume cap at EUR700bn?

KR: If one of these countries were to need further support, a new programme and a new Memorandum of Understanding would be necessary. Granting such a programme would require a decision at political level. It would in principle not be undertaken by the EFSF, which will not be able to initiate new programmes after 30 June 2013.

20. Will EFSF and ESM be parallel in the market?

CF: Yes, it is likely but EFSF and ESM issuance will be managed by the same team ensuring full coordination between the two entities but working on the basis of two separate balance sheets.

21. There is a theoretical possibility that the ESM would take over EFSF bonds in the ESM Treaty. Will this happen? What would be the process?

KR: No, this is not currently envisaged.

ON FUNDING

22. Do you know when ESM will start to issue and what its yearly funding volume will be?

CF: Any ESM issuance will of course depend upon if and when an ESM Member State submits a request for financial assistance. Similarly, the funding volume cannot be known until a request for assistance has been made and a programme has been determined.

23. What is your view on the funding costs – EFSF v ESM? Do you expect ESM bonds to be trading tighter than EFSF?

CF: Thanks to the stronger and more transparent capital structure (paid-in capital) of the ESM, it may be envisaged that the ESM would obtain more favourable funding costs. However, these costs also depend on market conditions, thus it may be premature to speculate on this issue.

24. *Will the funding for the Spanish bank recap be done by means of bonds transferred to Spain (i.e. cashless operation) or by means of capital market funding?*

CF: The funding for the Spanish bank recap will in general take the form of EFSF or ESM bonds provided to FROB (the Spanish bank restructuring agency).

25. *What is the EFSF's funding strategy until the end of 2012? How much can we expect in 2013?*

CF: EFSF will continue its funding strategy which is a combination of issuance of benchmark bonds and a short term bill programme. For the remaining quarter of 2012, the EFSF is expected to raise €11 billion in long term funding and almost €8.5 billion in bills.

According to the long-term funding programme, €40.5 billion in bonds will be issued by the EFSF in 2013. An additional €12 billion will be raised through the bill programme.

26. *Will the EFSF and/or the ESM also issue *Schuldschein* loans? This would especially be in the interest of German insurance companies.*

CF: This is an interesting option, and we do try to provide investors with opportunities that match their needs, but again it is too early to give a definitive answer.

27. *What will be the funding strategy of the ESM?*

CF: The ESM will apply a diversified funding strategy like the EFSF, which entails the use of a variety of instruments and maturities to ensure the efficiency of funding and continuous market access. One feature of this strategy is that funds raised through various instruments are not attributed to a particular country. The funds are pooled and then disbursed to programme countries. Whilst it is possible for the ESM to issue in different currencies such as USD, the ESM will initially focus on establishing a curve of benchmarks denominated in euro.

ON SECONDARY MARKET PURCHASES

28. *How would secondary market purchases work?*

KR: Secondary market purchases conducted by the ESM would be based on the same procedure as the one agreed for the EFSF. In both cases the ECB would act as fiscal agent.

29. *What is the exact procedure? How is the ECB involved?*

KR: Secondary market support could be provided for ESM Members requesting a secondary market support facility. Such a ESM member may be under a macroeconomic adjustment programme or a precautionary programme. The conditionality attached to the secondary market support facility would be spelled out in a MoU.

Decisions on interventions on the secondary market would be taken on the basis of an analysis of the ECB recognising the existence of exceptional financial market circumstances and risks to financial stability for the euro area.

With respect to the announcement by the President of the European Central Bank, Mario Draghi, on 6 September of the decision to undertake Outright Monetary Transactions (OMTs), it should be noted that interventions by the ECB on the secondary market will be carried out only for countries that have requested EFSF/ESM support and where such a request has been approved by the Eurogroup. The ECB would purchase bonds on the secondary market, while the EFSF/ESM would conduct primary market purchases.

30. Are you considering pre-funding to be equipped for secondary market purchases?

CF: This is not an issue currently under consideration.

OPTIMIZING EFSF/ESM FIREPOWER

31. Can we expect the EFSF to provide partial risk protection certificates or co-investment funds in the near future? Or is it only a theoretical option, which will not be used? Are these only mechanisms for the EFSF, or also for the ESM?

KR: Our Member States are considering extending to the ESM the options introduced last year to maximise the capacity of the EFSF: the partial protection certificates and the co-investment funds. These options could be used to support market access for countries within a full or precautionary programme.

Technical work is under way and will be considered in due course by the ESM governing bodies once the ESM is operational.

ON SPAIN

32. Could Spain itself - the sovereign / government - use parts of the EUR100bn support assigned for the banking sector?

KR: No. The Memorandum of Understanding for the Spanish banking system does not allow any other use. If the full EUR 100 billion earmarked is not required for the Spanish bank recapitalisation, it will be a political question whether the remaining amounts, based on a new Memorandum of Understanding, would be allocated to Spain for other purposes.

