



Risk management at ESM & EFSF

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Mumbai, November 2016

Agenda

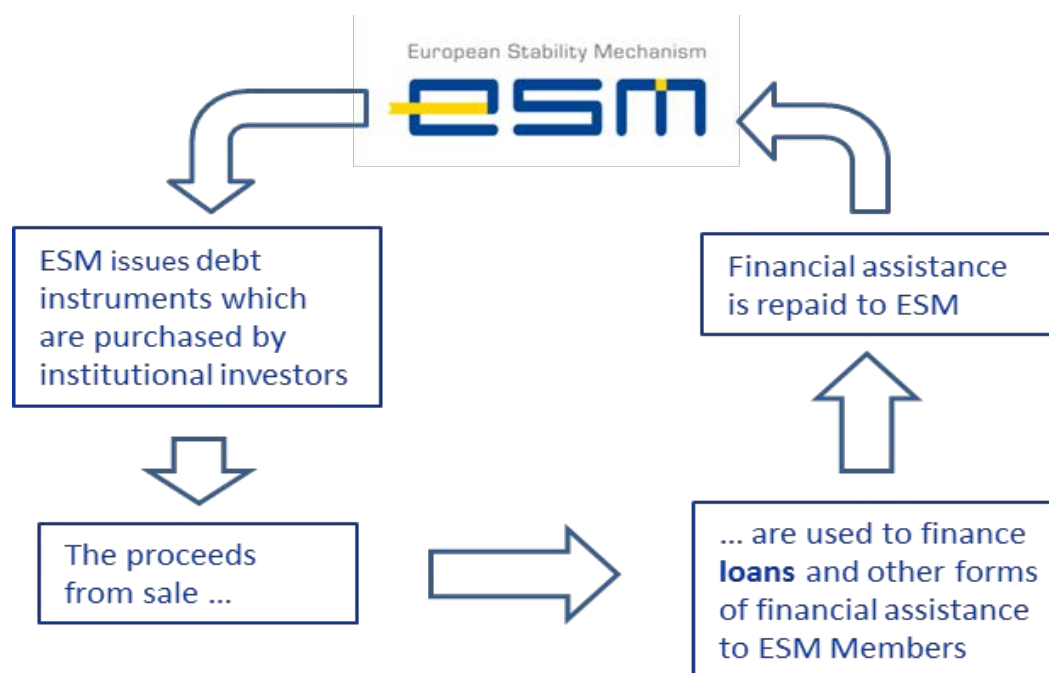
- i. **A brief summary about the ESM**
- ii. Risk Framework at the ESM
- iii. Risk Culture at the ESM
- iv. Questions

i. Focus on EFSF and ESM

- The EFSF and ESM are the first resolution mechanisms of large magnitude created in the world since Bretton Woods
- In June 2010, The European Financial Stability Facility (EFSF) was created as a temporary crisis resolution mechanism by the euro area Member States
- Between 2010 and 2012, the EFSF has provided financial assistance to Ireland, Portugal and Greece. The assistance was financed by the EFSF through the issuance of bonds and other debt instruments on capital markets
- In October 2012, the ESM was created, as sole and permanent mechanism for responding to new requests for financial assistance by euro area member states. It has provided loans to Spain and Cyprus and more recently (2015) it has provided financial support to Greece

i. ESM's mission and activities

- The ESM's mission is to **provide financial assistance** to ESM Members experiencing or threatened by severe financing problems.
- The assistance is granted if it is indispensable to **safeguard the financial stability** of the euro area as a whole and of the ESM Members.
- How is this financed and carried out?



i. EFSF & ESM: overview



Legal Structure	Private company under Luxembourg law	Inter-governmental institution under international law
Duration	June 2010-June 2013 No new programmes from 1 July 2013	Permanent institution
Capital structure	Backed by guarantees of euro area Member States	Subscribed capital of €704.8bn* €80.55bn in paid-in capital €624.3bn in committed callable capital
Maximum Lending capacity	€88bn committed for Ireland, Portugal & Greece	€500bn
Creditor status	Pari passu	Preferred creditor status (after IMF) **
Credit Rating	AA (negative) / Aa1 (stable) / AA (stable)	- / Aa1 (stable) / AAA (stable)
Risk Weighting / HQLA designation	0% Risk Weighted / High Quality Liquid Asset for LCR***	

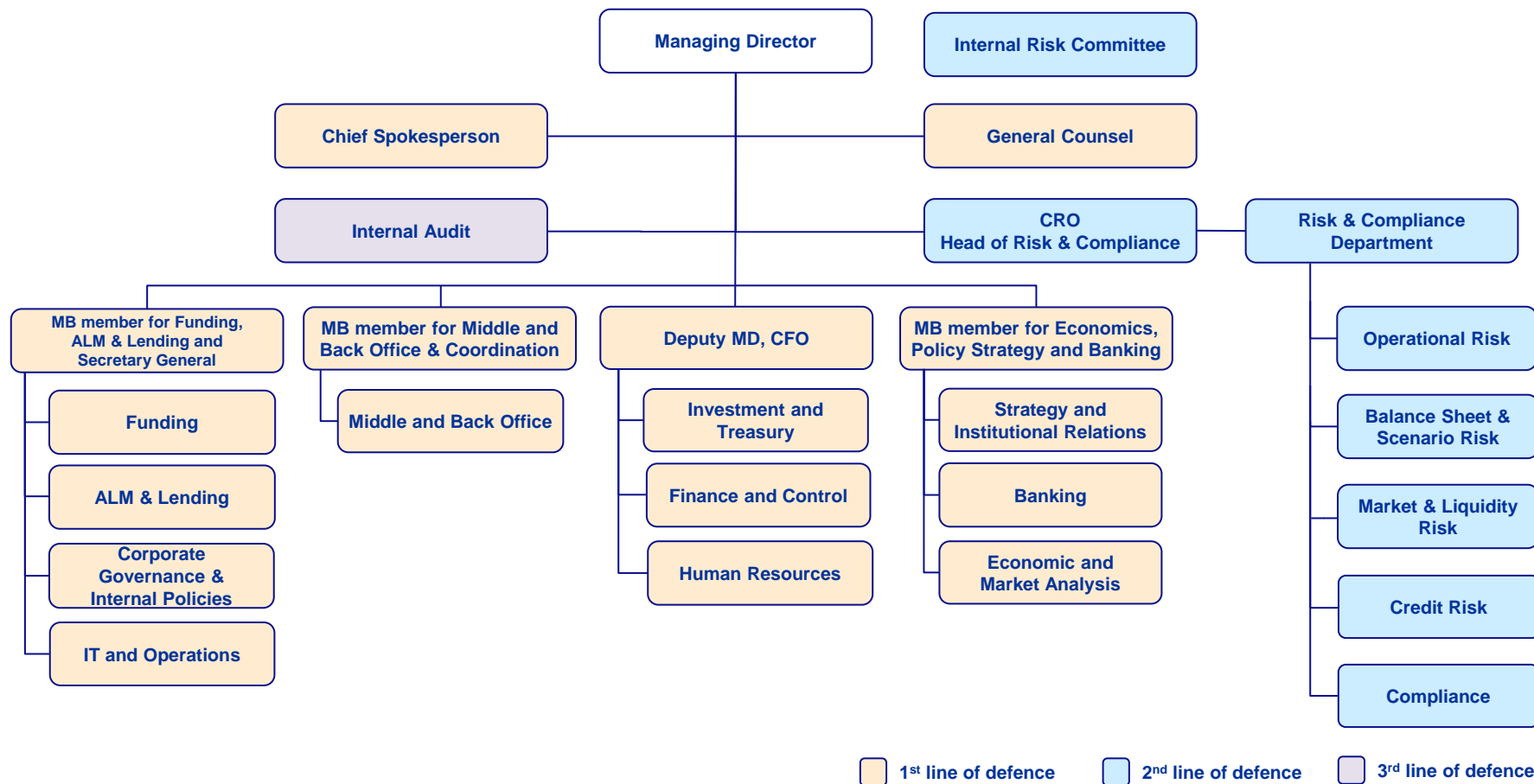
* The initial subscribed capital of €700 bn has increased since the accession of Latvia in March 2014 and Lithuania in February 2015

** For the financial assistance for recapitalisation of the Spanish banking sector, pari passu will apply

*** Regulation (EU) no. 575/2013 (Capital Requirements Regulation), Article 118. Following a decision published by the Basel Committee on Banking Supervision on 18 March 2014, EFSF & ESM securities will be included in the list of entities receiving a 0% risk weighting under Basel II, as well as received HQLA categorisation for Liquidity Coverage Ratio computation under Basel III

i. ESM organigram through the Three Lines of Defence

- The Three Lines of Defence framework allows to share risk management responsibility across the ESM/EFSSF;
- The Risk function remains independent and able to intervene when required.



ii. Key principles of the Risk and ALM Framework at the ESM

- Risk management at the ESM is a shared responsibility across all the functions and it is based on the following key principles:
 - Established risk framework, regularly reviewed and updated to reflect changes to risk appetite;
 - **Three lines of defence** approach to risk management;
 - Fully staffed Risk and Compliance function with relevant expertise and capacity;
 - A four-step process allowing for rapid identification and mitigation of risks;
 - Robust governance applied through Internal Risk Committees and Board Risk Committees;
 - Addition of forecasting/stressing capacity ongoing.

ii. Risk Framework - Risk Policies

High Level Principles for Risk Management

Investment Guidelines

Borrowing Guidelines

ESM Risk Policy and Risk Policy Annex

Internal Risk Policies

Operational Risk

Credit Risk

Funding Liquidity Risk

Market Liquidity Risk Policy

[Market Risk Policy by 2016]

Related Operational Procedures/Manuals

BoD Approved

IRC Approved

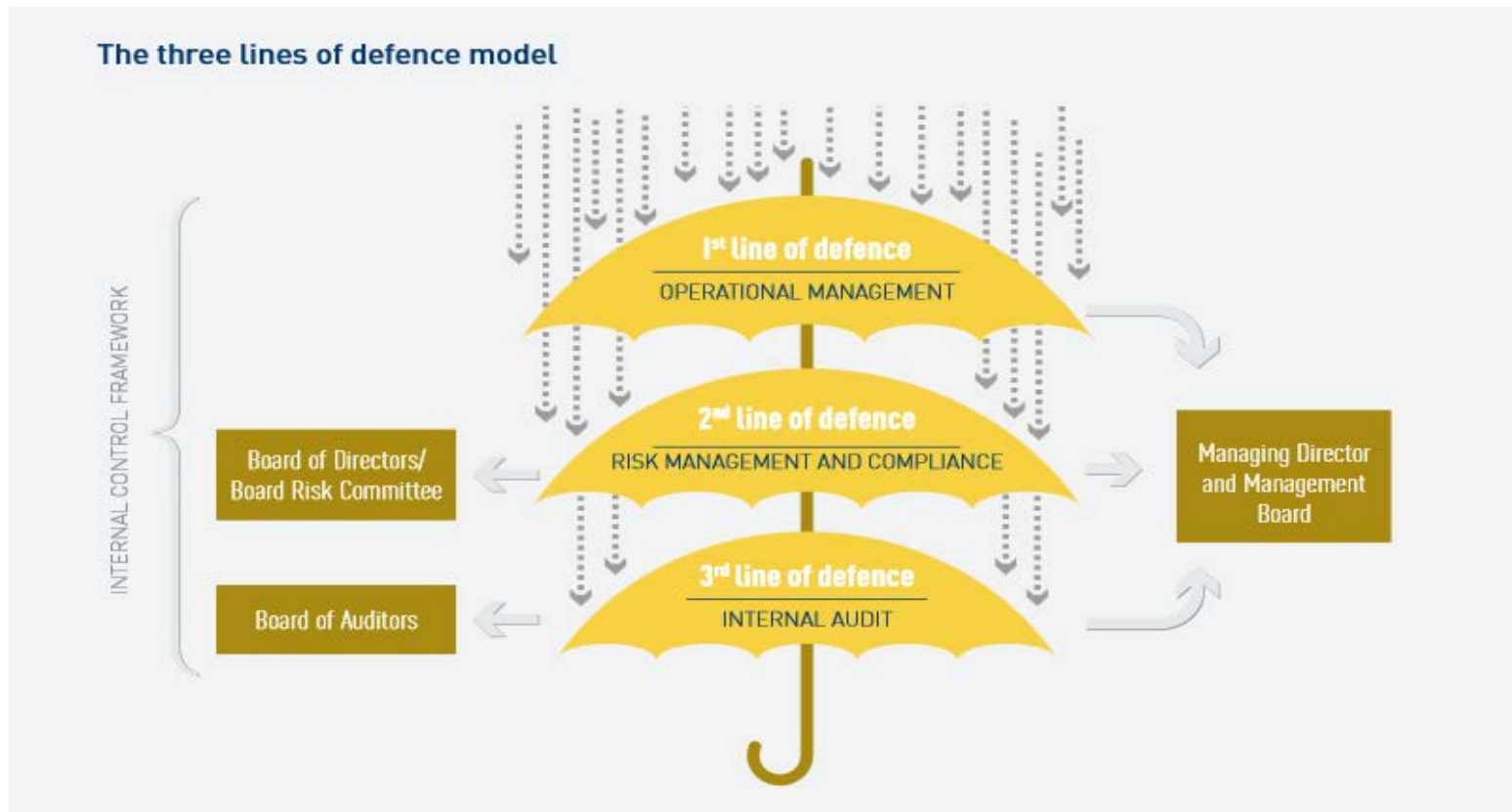
Head of function

ii. Basic risk taxonomy

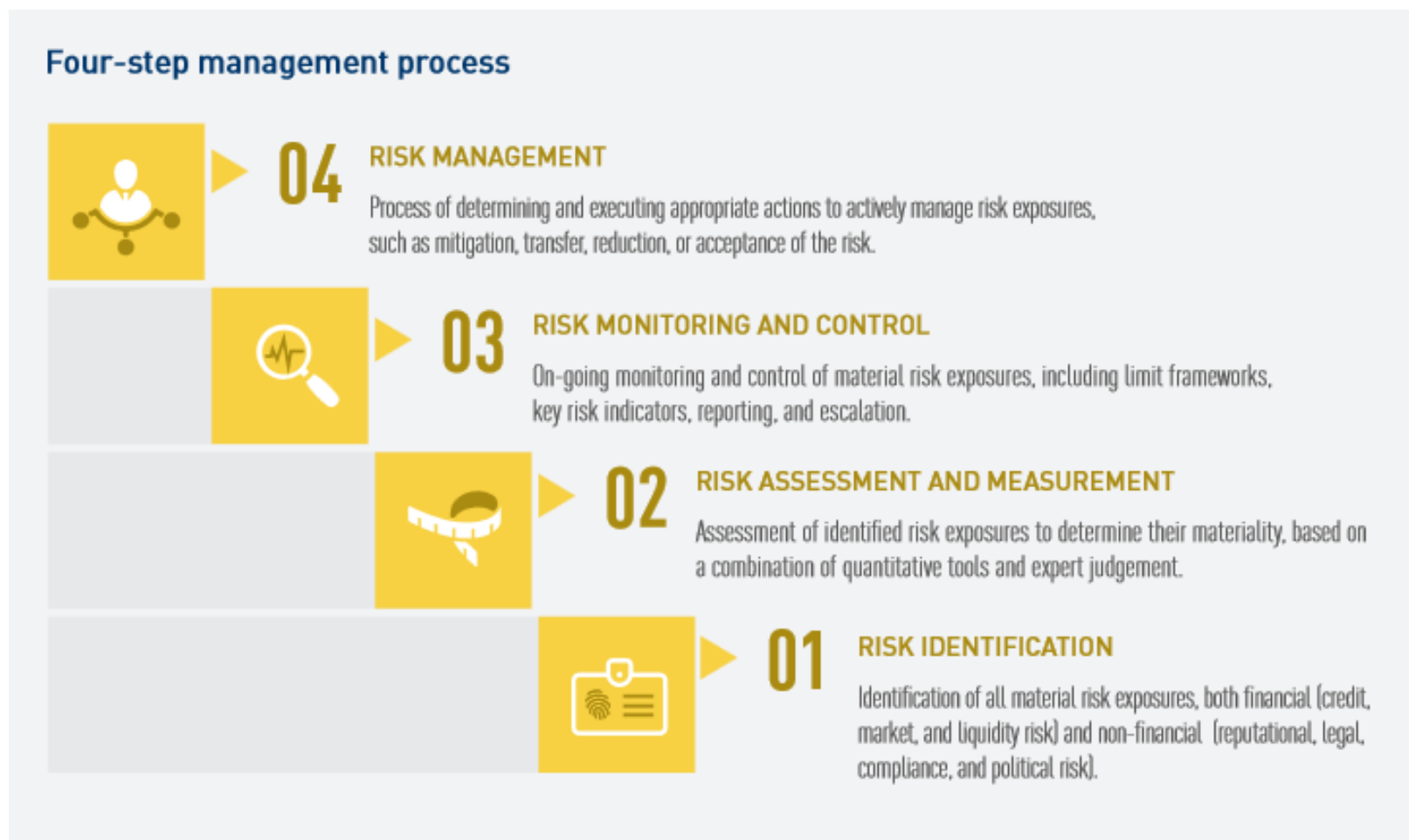
1 Governance and policies	2 Capital Planning	3 Tools and infrastructure	4 Reporting	5 Credit risk	6 Market risk
<ul style="list-style-type: none"> 1.1 Definition of risk strategy and policies 1.2 Definition of risk approved products (investments) 1.3 Definition of limits and limit structure 1.4 Communication to rating agencies and investors 	<ul style="list-style-type: none"> 2.1 Collaboration with ALM on capital planning 2.2 Communication to BoD/BoG 	<ul style="list-style-type: none"> 3.1 Selection, operation and maintenance of risk software 3.2 Development of risk models 3.3 Definition of KPIs for measurement 3.4 Definition of stress-testing 3.5 Communication to rating agencies BoG 	<ul style="list-style-type: none"> 4.1 Data quality control 4.2 Development of format of reports and dashboards 4.3 Production of reports and dashboards 4.4 Communication to member states 	<ul style="list-style-type: none"> 5.1 Validation and back testing of credit risk models 5.2 Measurement of KPIs 5.3 Implementation of stress testing for credit risk 5.4 Daily reporting and monitoring of credit risk position and limits and on guarantee consumption/ financing capacity 5.5 Escalation of limit breaches and suggestion of countermeasures 	<ul style="list-style-type: none"> 6.1 Validation and backtesting of market risk models 6.2 Measurement of KPIs 6.3 Implementation of stress testing for market risk 6.4 Daily reporting and monitoring of market risk position and limits 6.5 Escalation of limit breaches and suggestion of countermeasures
7 ALM risk	8 Liquidity risk	9 Counterparty risk	10 Operational /IT risk	11 Reputational risk	12 Legal Risk
<ul style="list-style-type: none"> 7.1 Validation and backtesting of ALM risk models 7.2 Measurement of KPIs 7.3 Implementation of stress testing for ALM risk 7.4 Daily reporting and monitoring of ALM risk position and limits 7.5 Escalation of limit breaches and suggestion of countermeasures 	<ul style="list-style-type: none"> 8.1 Validation and backtesting of liquidity risk models 8.2 Measurement of KPIs 8.3 Implementation of stress testing for liquidity risk 8.4 Daily reporting and monitoring of liquidity risk position and limits 8.5 Escalation of limit breaches and suggestion of countermeasures 	<ul style="list-style-type: none"> 9.1 Validation and backtesting of counterparty risk models 9.2 Measurement of KPIs 9.3 Implementation of stress testing for counterparty risk 9.4 Daily reporting and monitoring of counterparty risk position and limits 9.5 Escalation of limit breaches and suggestion of countermeasures 	<ul style="list-style-type: none"> 10.1 Identification of operational risk and assessment of exposure 10.2 Monitoring and reporting on operational and outsourcing risk evolution 10.3 Mitigation of operational risk 10.4 Training 10.5 Drill exercise 	<ul style="list-style-type: none"> 11.1 Identification of reputational risk and assessment of exposure 11.2 Monitoring and reporting on reputational risk 11.3 Mitigation of reputational risk 	<ul style="list-style-type: none"> 12.1 Identification of legal risk and assessment of impact 12.2 Monitoring and reporting on legal risk 12.3 Mitigation of legal risk

ii. Risk Framework - Three lines of defence

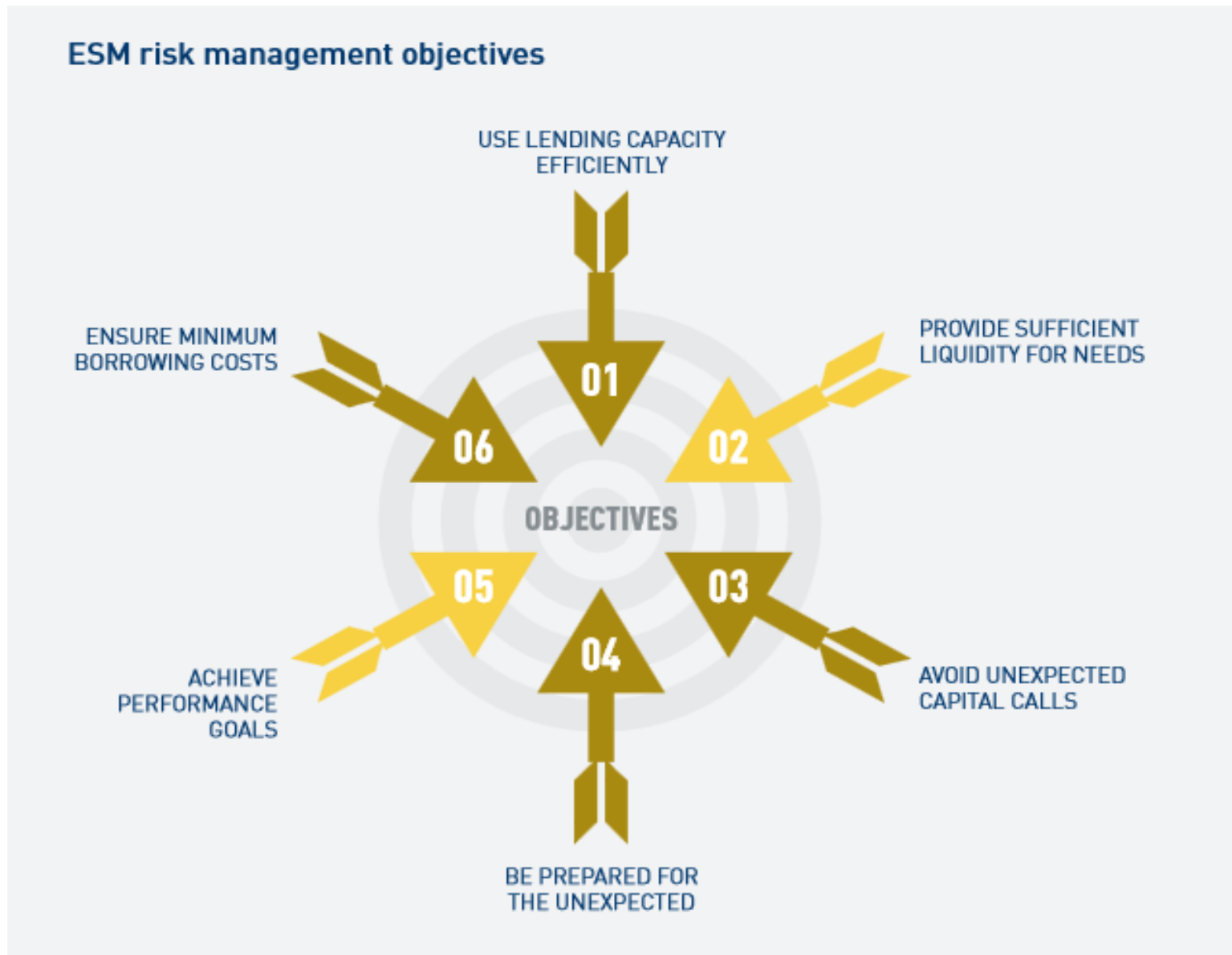
- Risk management at the ESM is a shared responsibility across all ESM functions;
- The Risk function represents the second line of defence and its activities are informed by the Internal Risk Committee – with around 11 meetings each year.



ii. Risk Framework - Four-step risk management process



ii. Risk Framework - Six risk management objectives



ii. Key missions for Risk and ALM at the ESM/EFSF

- i. Preserve highest rating as requisite for cheap funding
- ii. Monitor the lending activities
- iii. Keep market access for funding activities
- iv. Manage liquidity according to strict internal parameters
- v. Preserve paid-in capital
- vi. Keep investments aligned to strict credit risk criteria



Risk Heatmap



ii. ESM and EFSF credit ratings

- ESM and EFSF are committed to maintaining the highest possible credit rating to successfully fulfil their mandate;
- Constant dialogue with rating agencies;
- The possible rating impact due to changes in Member States' creditworthiness and implementation of ESM/EFSF policies are constantly monitored.

	S&P		Fitch		Moody's		DBRS (unsolicited)	
	Long Term Rating	Rating Outlook	Long Term Rating	Rating Watch	Long Term Rating	Rating Outlook	Long Term Rating	Rating Trend
ESM	n.a.	n.a.	AAA	Stable	Aa1	stable	AAA	stable
EFSF	AA	negative	AA	Stable	Aa1	stable	AAA	stable

iii. Risk Culture at the ESM

- A key role of the risk function is **to develop and maintain a healthy risk culture** at the ESM.
- In the last twelve months, the risk function provided:
 - **Training** on Treasury Risk, Covered Bonds, Counterparty Risk open to all ESM staff;
 - **Training** on Operational Risk/Fraud to over 100 ESM employees (target: 100% staff by end of 2016);
 - **Induction sessions to new staff** and refresher courses on Compliance matters;
 - **Risk Seminars** with subject matter experts on different risk disciplines and workshops with other IFI CROs;
 - **Ongoing and active exchange of views with other IFIs** – either via bilateral meetings or participating in CRO and sectorial fora (e.g. IFI Op Risk Forum)
 - **Risk Culture Workshops** – Risk met with all ESM divisions to discuss how best to further develop and maintain a sound risk culture; some of the above initiatives resulted from this set of meetings.

ii. One risk culture?

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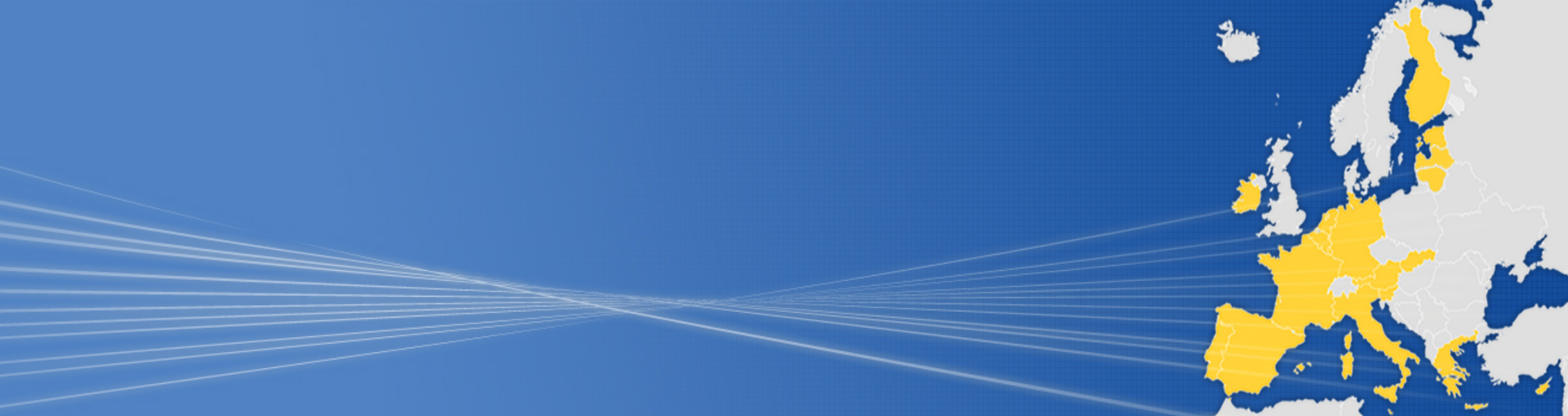
ONE RISK CULTURE



ii. Risk Culture – Some basic principles

- The exchange of views between Risk and other divisions highlighted a series of key concepts/values for a sound risk culture:
- **Solution driven/problem solving attitude**
- **Facts are kings**
Each function should base actions and decisions on hard facts and key requirements – less theory more praxis
- **A sharing culture**
Sharing of common agenda and sharing objectives
- **Early Involvement**
Each function should feel they have been involved early enough (avoiding ‘the last to know’ syndrome)
- **Accountability/Delegation**
Individuals in both functions should feel accountable and delegated
- **Escalation**
Processes should be made clear (e.g. ‘I need to talk to the boss’)
- **A crowd-thinking principle**
Each opinion counts and Risk should be able to summarise and represent the different views, though bringing it the risk mitigation and management angle
- **No silos mentality**
We are one institution and each one benefits from each other work
- **Validation and Oversight**
Two key tools for Risk to support the business to build a risk-sound environment

Questions?



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