

FAQ on the ESM direct recapitalisation instrument

The ESM direct recapitalisation instrument (DRI) is now operational. This follows the completion by all 18 euro area Member States of their own national procedures and a unanimous decision by the ESM Board of Governors (the euro area finance ministers chaired by Eurogroup President Jeroen Dijsselbloem).

The DRI is one element of the wider package of instruments that have been introduced to support the euro area's banking union. It may be used in very specific circumstances to recapitalise euro area financial institutions as a last resort when all other instruments, including the bail-in mechanism, have been applied.

- 1 – The ESM may already provide financial assistance to euro area Member States for the purpose of recapitalising financial institutions. Why is it necessary to introduce a new instrument, allowing for direct recapitalisation of institutions by the ESM?

Until the creation of the direct recapitalisation instrument, the ESM could only recapitalise financial institutions indirectly. In this case, the ESM provides a loan to the government of a euro area Member State. With these funds the government then recapitalises the financial institutions, which is how the ESM provided assistance to Spain. However, such assistance adds to the beneficiary country's public debt, which could have a negative impact on market sentiment. The link between governments and banks (described as a "vicious circle") has been widely regarded as a crucial destabilising factor for some euro area countries. As a result, the leaders of euro area countries decided in June 2012 to develop an instrument that would allow certain institutions¹ to strengthen their capital position without placing a large burden on the country where the institution is incorporated.

- 2 – Is direct recapitalisation one of the elements of the banking union?

Yes, in December 2012 the European Council (the Heads of State or Government of EU countries) agreed on the key building blocks of the future banking union. It consists of the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) and funding arrangements, which includes the direct recapitalisation instrument by the ESM.

- 3 – What is the significance of the new instrument?

When the instrument was first proposed, it was supposed to cut the link between troubled credit institutions and sovereigns. However, it soon became apparent that the remaining building blocks of the banking union would most likely achieve this aim without the need for DRI to provide substantial funds.

More specifically, the bail-in of private investors (in accordance with the Bank Recovery and Resolution Directive), and the contribution of a national resolution fund (or Single Resolution Fund from 2016) as a precondition for the DRI to be used has shifted the bulk of potential financing from the ESM to the institutions themselves, along with their investors and creditors. With all the components of banking union set to become operational by January 2016, the ESM direct recapitalisation instrument will only

¹ Please refer to FAQ 4 below regarding eligible institutions for direct recapitalisation.



be applied when all burden sharing arrangements specified in the DRI Guideline prove insufficient to return a bank to viability, the eligibility criteria regarding the requesting ESM Member and institution requiring recapitalisation (see Questions 5 and 6) are met and if indirect recapitalisation is not possible.

➤ 4 – What types of institutions can be directly recapitalised by the ESM?

The direct recapitalisation instrument is applicable to systemically relevant credit institutions, financial holding companies (i.e. financial institutions with subsidiaries that are exclusively or mainly financial institutions) and mixed financial holding companies (i.e. parent entities, which together with subsidiaries constitute a financial conglomerate), as defined in relevant EU legislation.²

➤ 5 – What are the eligibility criteria regarding the requesting ESM Member?

The requesting ESM Member would have to be unable to provide financial assistance to the beneficiary institution without very serious effects on its own fiscal sustainability. The use of direct recapitalisation could also be considered if other solutions risked endangering the continuous access to markets of the requesting ESM Member. This could in turn force the country to seek financial assistance from the ESM. In addition, ESM financial assistance would have to be considered indispensable to safeguard the financial stability of the euro area as a whole or of its Member States.

➤ 6 – What are the eligibility criteria with respect to the beneficiary institution requiring recapitalisation?

The beneficiary institution would have to be (or likely to be in the near future) unable to meet the capital requirements established by the ECB in its capacity as supervisor. It would also have to be unable to obtain sufficient capital from private sources and the foreseen bail-in would not be sufficient to address the anticipated capital shortfall. The beneficiary institution in question must also be of systemic relevance or pose a serious threat to the financial stability of the euro area as a whole or of its Member States.

➤ 7 – What is the procedure for requesting support?

An ESM Member requesting direct recapitalisation should address the request to the Chairperson of the ESM Board of Governors. The request should among others include the possible amount of capital needs, an opinion of the competent supervisory authority on the institution's financial situation and the result of the most recent stress test. If the institution is not directly supervised by the ECB, then as a precondition for direct recapitalisation, the ESM Board of Governors will request the ECB to take over its direct supervision.

The European Commission, in liaison with the ECB and IMF (wherever appropriate) will assess whether the requesting ESM Member meets the eligibility criteria specified in the ESM Treaty and the Guideline on the direct recapitalisation instrument. Likewise, the ESM, in liaison with the European Commission, the competent resolution authority and the ECB in its capacity as the supervisor, will assess whether the institution meets the eligibility criteria specified in the Guideline on the direct recapitalisation instrument. Based on these assessments, the ESM Board of Governors will decide whether the eligibility criteria are met and if so, may decide to grant, in principle, financial assistance for direct recapitalisation.

➤ 8 – Does the beneficiary institution have to be restructured?

² Council Regulation (EU) no 1024/2013 and Regulation (EU) no 575/2013 of the European Parliament and Council.



Yes. After notifying the European Commission of the intention to grant state aid, a restructuring plan will be drawn up to ensure the viability of the institution after recapitalisation. This plan will be submitted to the European Commission for approval. In parallel, the ESM's Managing Director, in liaison with the Commission and the ECB, and with the assistance of independent experts, will conduct a due diligence exercise, including a rigorous economic valuation of the assets.

➤ 9 – What are the next steps in the formal procedure?

The European Commission, in liaison with the ECB, the ESM, and IMF (wherever appropriate) will negotiate with the requesting ESM Member a Memorandum of Understanding (MoU) detailing the policy conditions concerning that Member's financial sector. The MoU will be signed by the European Commission on behalf of the ESM, following approval by the ESM Board of Governors.

The ESM, in liaison with the Commission, the ECB and the requesting ESM Member, will establish further institution-specific conditions in addition to those required under the state aid framework.

The ESM Managing Director in liaison with the European Commission, ECB and requesting ESM Member, will prepare a proposed outline for a financial assistance facility agreement (FFA) and an institution specific agreement (ISA), including the envisaged amounts to be provided to the institution concerned, to be adopted by the ESM Board of Governors.

Following a decision of the European Commission setting out state aid conditionality, the ESM Board of Directors will approve the FFA and the ISA, and the disbursement of the assistance, subject to completion of prior actions, if any, and the approval of the restructuring plan by the European Commission.

➤ 10 – Will the requesting ESM Member contribute financially to the recapitalisation?

Yes. A burden sharing scheme will determine the contributions of the requesting ESM Member and the ESM. The scheme will comprise two parts:

- (i) If the beneficiary institution has insufficient equity to reach the legal minimum Common Equity Tier 1 of 4.5%³ (Common Equity Tier 1 is a category of capital consisting of common shares and retained earnings), the requesting ESM Member will be required to make a capital injection to reach this level. Only then will the ESM participate in the recapitalisation.
- (ii) If the beneficiary institution already meets the capital ratio mentioned above, the requesting ESM Member will be obliged to make a capital contribution alongside the ESM. This contribution will be equivalent to 20% of the total amount of public contribution in the first two years after the Direct Recapitalisation Instrument enters into force. Afterwards, the ESM Member's contribution will amount to 10% of the total public contribution.

The ESM Board of Governors will have the right to partially or fully suspend an ESM Member's contribution. This refers to exceptional cases when the ESM Member is not able to contribute up-front due to fiscal reasons.

³ This will take place following a valuation of the institution's assets conducted under the guidance of the ESM in liaison with the ECB and European Commission, and under a sufficiently prudent stress test scenario.



➤ 11 – Will there be a bail-in or other form of private sector contribution?

Yes. Direct recapitalisation by the ESM will only be considered if private capital resources are engaged first. For a transitional period until 31 December 2015, a bail-in equal to 8% of total liabilities, including own funds of the beneficiary institution, will be applied. In addition, a contribution from the Member State's national resolution fund will be made, up to the 2015 target level of contributions to the resolution fund as it is defined under the BRRD and Single Resolution Mechanism.

From 1 January 2016, the obligatory private sector contribution (as a precondition for the use of direct recapitalisation by the ESM) will be as defined in the Bank Recovery and Resolution Directive (BRRD). This requires that the following three conditions must be met:

- a bail-in equal to an amount of not less than 8% of total liabilities including own funds of the beneficiary institution;
- a contribution of the resolution financing arrangement of up to 5% of the total liabilities including own funds;
- a write-down or conversion in full of all unsecured, non-preferred liabilities other than eligible deposits (excluding certain types of liabilities listed in the BRRD).

➤ 12 – What kind of conditionality will apply for the ESM Member and the institution requesting the use of direct recapitalisation and for the beneficiary institution?

There will be conditions applying to the recapitalised institution, established under EU state aid rules. In addition, the ESM, in liaison with the Commission and the ECB, can add additional institution-specific conditions. These can include rules on the governance of the institution, remuneration of management and bonuses. Other policy conditions may be related to the general economic policies of the ESM Member concerned. They will be included in the Memorandum of Understanding (MoU) attached to the financial assistance.

➤ 13 – Will the ESM become a shareholder in the beneficiary institution?

Yes. As a general rule, the ESM will acquire common shares in the beneficiary institution. The ESM Board of Governors may authorise the acquisition of other capital instruments, such as special shares, hybrid capital instruments or contingent capital in order to fulfil supervisory capital requirements.

➤ 14 – Will the ESM establish a subsidiary through which it would conduct direct recapitalisation operations?

The ESM Board of Governors will establish a (internal) subsidiary body to undertake the recapitalisation operations. This will allow for full transparency of the operations. In order to enable external investors to participate in the recapitalisation alongside the ESM, the ESM may also establish sub-entities dedicated to the financing, implementation and ownership of capital instruments related to the recapitalisation.

➤ 15 – Will the ESM be able to influence the business model and governance of the beneficiary institution?

Yes, the ESM's objective is to ensure that the recapitalised institution has strong governance structures and processes. This may include appointing and dismissing members of the institution's board of directors, senior management and imposing remuneration schemes for management. However, the ESM will not get involved in the day-to-day management of the beneficiary institution.

➤ 16 – Is there a cap on the amount of resources available for use under the direct recapitalisation instrument?



Yes, in order to preserve the ESM's lending capacity for other instruments, there is a limit on the total amount of ESM resources available for direct recapitalisation of institutions. This also provides transparency for investors and helps preserve the high creditworthiness of the ESM. The limit is set at €60 billion.

➤ 17 – How will direct recapitalisation of institutions impact the ESM's lending capacity?

Should the ESM use its direct recapitalisation instrument, it would as a rule acquire common shares in the beneficiary institution. As acquiring a stake in an institution is considered to be more risky than granting a loan to a country, the impact on the ESM's capital and creditworthiness is higher in the case of direct recapitalisation than in case of granting loans. Because of the different risk profile, €1 for ESM direct recapitalisation of institutions would reduce the ESM's lending capacity by significantly more than €1 in order to maintain ESM's high creditworthiness, which is crucial for its overall operation in capital markets and market access.

However, the maximum lending capacity will only be adjusted when the ESM actually enters into direct recapitalisation programmes. The ESM has a maximum lending capacity of €500 billion. So far, the ESM has disbursed €41.3 billion to Spain in the context of an assistance programme for the financial sector (indirect recapitalisation). Furthermore the ESM has committed €9 billion to Cyprus of which the majority has now been disbursed.

➤ 18 – Could direct recapitalisation be applied retroactively, so that the ESM directly recapitalises troubled institutions in countries that have received financial assistance from the EFSF and ESM?

The potential retroactive application of the instrument will be decided on a case-by-case basis and by mutual agreement of ESM Members.

➤ 19 – Could direct recapitalisation by the ESM be used as a precautionary instrument?

No, the ESM direct recapitalisation instrument cannot be used as a precautionary instrument as defined in Article 32(4)(d)(iii) of BRRD.

➤ 20 – Who will monitor the beneficiary institution's compliance with the institution-specific conditions and the ESM Member's compliance with policy conditions?

Compliance with the conditions related to state aid rules will be monitored by the European Commission. Compliance with other institution-specific conditions will be carried out by the ESM in liaison with the European Commission, and the ECB in its capacity as supervisor. In both cases, a monitoring trustee may be appointed to assist in the monitoring.

Compliance with policy conditions by the ESM Member concerned will be monitored by the European Commission, in liaison with the ECB, ESM, and IMF (wherever appropriate). The monitoring institutions may be assisted by external auditors or monitoring trustees.

➤ 21 – Will the ESM eventually sell its shares in the recapitalised institution?

Yes, the ESM's participation is temporary by its nature. The ESM will actively seek opportunities to exit the investment. The ESM Board of Directors may decide to sell the capital instruments acquired in full or in tranches. The recapitalisation operation may also be terminated by the redemption or buy-back of capital instruments of the recapitalised institution.

➤ 22 – Is DRI now operational?



Yes, after the decision of the ESM Board of Governors on 8 December 2014, the direct recapitalisation instrument has been added to the ESM's financial assistance instruments. The ESM has prepared itself internally and is ready to conduct a bank recapitalisation should the need arise.

➤ 23 – Will the use of the direct recapitalisation instrument require a full macroeconomic adjustment programme for the requesting ESM Member State?

The use of this instrument may be requested by ESM Members within or outside of the confines of a macroeconomic adjustment programme. The financial assistance has in any event to be subject to specific conditionality relevant to this instrument. Conditionality will be of an institution-specific, sector-specific or macro-economic nature.