

FROM CRISIS TO STABILITY

**HOW TO MAKE THE EUROPEAN STABILITY MECHANISM
TRANSPARENT AND ACCOUNTABLE**

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Transparency International EU leads the movement's EU advocacy, in close cooperation with national chapters worldwide, but particularly with the 25 national chapters in EU Member States.

Transparency International EU's mission is to prevent corruption and promote integrity, transparency and accountability in EU institutions, policies and legislation.

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LIST OF ABBREVIATIONS

BoA	Board of Auditors
BoD	Board of Directors
BoG	Board of Governors
CoC	Code of Conduct
CJEU	Court of Justice of the European Union
DRI	Direct Recapitalisation Instrument
ECA	European Court of Auditors
ECB	European Central Bank
EFSF	European Financial Stability Facility
EFSI	European Fund for Strategic Investments
EFSM	European Financial Stability Mechanism
EIB	European Investment Bank
EMU	Economic and Monetary Union
ESM	European Stability Mechanism
EU	European Union
GDP	Gross Domestic Product
GLF	Greek Loan Facility
HFSF	Hellenic Financial Stability Fund
IMF	International Monetary Fund
MoU	Memorandum of Understanding
PPS	Post-programme surveillance
SAI	Supreme Audit Institutions
TEU	Treaty on European Union
TFEU	Treaty on the Functioning of the European Union



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EXECUTIVE SUMMARY

Founded in 2012, the ESM has become a crucial actor in the EU's economic governance: it sells bonds on behalf of the Eurozone as a whole, and finances EU financial assistance programmes for countries in need. With less than 200 staff, most of its operations outsourced to other institutions, and its highest governing body indistinguishable from the informal Eurogroup, this study by Transparency International EU shows the EU's bailout fund has not received the attention it deserves.

When a government loses access to financial markets and applies for a bailout, it becomes even more imperative to hold those institutions accountable that design and enforce the reform conditionality associated with ESM financial assistance. The ESM should be included in the EU treaty framework as a matter of priority, enabling it to take advantage of the EU's transparency and integrity acquis.

The story of the ESM's creation is a remarkable lesson in European integration. The EU treaties offered no legal basis for a bailout fund, and the 'no-bailout clause' contained in Art. 125 TFEU prohibits Member States from taking up each other's liabilities. But the euro was under serious threat and leaders had the political will to overcome these obstacles and set up a bailout fund outside of the EU treaties, leading to the creation of the ESM. It entered into force in late 2012, as the permanent successor to a series of temporary and ad hoc bailout funds, which had become necessary as a result of ever-higher interest rates demanded on private bond markets for a series of Eurozone countries. After the Greek bailout, 'contagion' set in, its financial troubles translated into drastically higher interest payments, with Portugal, Ireland and Cyprus also losing access to financial markets. The ESM loans replace countries' need to refinance their debt on private financial markets, allowing much lower interest rates than market rates, and giving countries time to make reforms and regain competitiveness.

Its access to financial markets hinges on Member States' credibility and credit rating, as they have to make up for any losses which the ESM may incur in the event of a sovereign default. The ESM therefore enjoys very favourable lending conditions, and can make these low interest rates available to countries in need at no cost for the other Member States. Financial assistance is granted in return for strict conditionality: bailout countries have to implement a series of reforms and budget cuts, with successive tranches

of ESM funds disbursed only when reform milestones have been met.

The EFSF and ESM have emerged as large players in the Euro area sovereign bond market, with outstanding bond volumes similar to that of a small euro area economy. While they have two distinct legal personalities, the EFSF and ESM share the same staff, management, and infrastructure, and incorporate the lessons learned throughout the euro area sovereign debt crisis. The ESM boasts world class audit arrangements, a code of conduct that ensures a high level of integrity, and a dedicated whistleblowing procedure that reflects best practice (see sections on integrity for details).

All countries but Greece have "graduated" from their macroeconomic adjustment programmes. After seven years of bailouts and reform conditionality, Greece is nearing the end of its third bailout. Our case study finds that it remains unclear if the targets for its primary budget surplus can realistically be achieved this time around, and whether the ESM and IMF can agree on a joint assessment of Greek debt sustainability. Increased transparency on economic modelling would help: there has been no accountability for the fundamentally wrong assumptions creditor institutions have made about the effects of austerity and fiscal multipliers on Eurozone economies. Enabling a reasoned debate between experts by releasing full details on the macroeconomic models, variables and assumptions used in the ESM's calculations should be a priority. An ongoing dispute with the IMF over Greek debt sustainability means the Fund is still threatening to pull out from the most recent bailout. What looks like an arcane conflict over the methodology of debt sustainability assessments, has wide ranging consequences for Greece's public finances and the delivery of public services for decades to come.

At the same time, the average maturity of around 32 years coupled with the ESM's very low interest rates mean that the costs for servicing Greek debt are drastically lower than on market terms. According to the ESM, the lengthened maturities and reduced and deferred interest payments saved Greece payments to the tune of 51 per cent of its 2015 GDP. The EFSF's and ESM's strong exposure to Greece gives the ESM a very distinctive outlook as a lender, making it directly vulnerable to the sustainability of Greece's debt.

The EU institutions have set themselves the target of bringing the ESM into the EU treaties by 2025.

This could be coupled with more far-reaching changes to the ESM's functioning; proposals include a 'European Monetary Fund' modelled after the IMF, which would integrate within the ESM the functions currently shared between the Troika or Quadriga institutions (Commission, European Central Bank, International Monetary Fund and the ESM). Giving the ESM a greater say over the programme reviews would need to come hand in hand with far greater accountability than is currently the case.

Both the negotiation of ESM bailout agreements and the monitoring of implemented reforms are prone to heavy-handed negotiating tactics and brinkmanship, as disagreements tend to escalate ahead of payment deadlines. As the ESM is the lender of last resort, the stakes are inevitably very high when its assistance is called upon. Failure to agree on reforms or on the status of their implementation can hold up the disbursement of funds and precipitate a country's default and disorderly exit from the Eurozone, with wide-ranging and unpredictable consequences for the euro area as a whole. Disagreements exist between programme countries and the Quadriga, but also between the IMF and the European institutions, on issues such as reform implementation, fiscal targets and debt sustainability.

These conflicts are inevitable and should be handled in a transparent way.

DECENTRALISED ACCOUNTABILITY OUTSIDE THE EU TREATIES

The conditionality attached to financial assistance programmes naturally challenges a government's sovereignty, forcing countries to make specific reforms as demanded by the creditor institutions – the only alternative being a disorderly exit from the Eurozone and subsequent default. This makes it even more important to hold the EU's economic governance institutions themselves accountable, which in the case of the ESM presents a series of challenges.

First, who is in charge of ESM programmes? They are negotiated by the Commission, in liaison with the ECB; monitored by the Quadriga, and green-lighted by the informal Eurogroup, which doubles as ESM Board of Governors. In effect, the Eurozone member states created an institution that is outside of the treaties, controlled directly by the ministers of finance of the Eurozone. At the same time, it delegates the negotiation and monitoring of reform conditionality to the Troika institutions, though the ESM started playing a stronger role in monitoring mission: the institutions formerly known as the Troika have become the Quadriga. In public perception and discourse, this tangled

web of overlapping institutions and responsibilities has led to the wide-spread perception that the EU, the Commission or the ECB were responsible for programme conditionality, rather than the Eurozone's Member States.

Second, the ESM is outside of the EU treaties. This has real consequences and makes EU-level accountability impossible. EU law is not applicable, e.g. the Access to Documents Regulation, the EU's fundamental rights charter or integrity provisions flowing from the EU Staff Regulation. First and foremost, becoming an EU institution would enable the ESM to take advantage of the services of and synergies with a range of EU bodies and institutions, such as the European Parliament, Ombudsman, Court of Auditors, Anti-Fraud Office, European Data Protection Supervisor and more. In practice, the ESM's Managing Director has always made himself available for hearings in the European Parliament, if asked to do so. This informal practice of answerability is commendable and should be formalised, to ensure regular updates on bailouts and reform conditionality. We endorse the European Parliament's call to bring the ESM into the EU treaties, and in turn call on the parliament to regularly assess the ESM's work in own-initiative reports.

Third, decentralised accountability towards the three largest Member States. Given the risk of very high losses in the event of a sovereign default, Member States have opted for an institutional design that gives themselves a tight grip over the ESM. This points to a deeper dilemma: On the one hand, it is impossible to hold a non-EU institution accountable at the European level; on the other hand, enabling decentralised accountability by giving each member a veto can worsen the brinkmanship and expose members in need of financial assistance to blackmail. To circumvent this dilemma, an emergency procedure was introduced: The Commission and ECB can jointly trigger this procedure, allowing the ESM to grant financial assistance or a further disbursement with 85 per cent of shareholders voting in favour, in effect circumventing the mutual consent requirement and potentially exposing ESM Member States to losses without requiring their acquiescence. It also means that Germany, France and Italy, which hold more than 15% of ESM shares, can on their own veto any financial assistance even if the European Commission and the ECB jointly deem it "essential" to the very survival of the single currency. In its judgement on the ESM, the German Constitutional Court clarified that no ESM funds can be made available without a specific vote from the German parliament, further cementing Germany's veto. The Presidents of the Commission, ECB, Eurogroup, European Council and European Parliament also expressed the concern that "as a result of its intergovernmental structure, [the ESM's] governance

and decision-making processes are complex and lengthy”, in the 2015 Five Presidents’ Report on deepening economic and monetary union.

ACCOUNTABILITY VIA INCREASED TRANSPARENCY

Finally, the difficulty in holding the ESM to account can be addressed partly by increasing the transparency of its operations. The ESM’s strict professional secrecy requirements are warranted for reasons of financial stability: the granting of ESM financial assistance or the restructuring of a country’s debt can have market-moving implications.

Lack of transparency has however been recognised as an issue, leading to the 2016 Transparency Initiative adopted in both the Eurogroup and the ESM. This improves the situation, with annotated agendas, summing-up letters and documents relating to bailouts published in a central location. Yet this will not allow citizens to find out what arguments and trade-offs compelled a change in position of their finance minister. Justifying this lack of transparency in a letter to the European Ombudsman, ESM Chairman Dijsselbloem even points out that “the Members of the Eurogroup may meet in their capacity of Governors under the [ESM]”, which is “of an intergovernmental nature and hence, not covered by the EU Treaties’ provisions on transparency”, allowing finance ministers

to take advantage of the Eurogroup’s informal nature and of the ESM intergovernmental set-up to ensure the secrecy of the Eurozone’s economic governance. The fact that most ESM decisions are taken in an informal consultative body without decision-making powers, and later formally adopted by the ESM’s Board once national procedures have run their course, does not make it easier for national parliaments and the general public to hold their finance ministers to account. The lack of transparency on high-level decision-making in the ESM and the Eurogroup, coupled with the outsized control finance ministers from the three largest Member States have over the negotiation and enforcement of reform conditionality, makes for a clear accountability gap between the electorate in a programme country and the institutions enforcing reform conditionality.



KEY POLICY RECOMMENDATIONS

TRANSPARENCY

- ✓ The European Stability Mechanism (ESM) should establish a procedure allowing the public to petition the ESM for access to documents drawn up by the ESM. This should be facilitated with a public register of documents.
- ✓ The ESM should clarify in its By-Laws what constitutes an “overriding public interest” as a basis for precluding the disclosure of ESM documents.
- ✓ Economic models and underlying assumptions used by the ESM, including those used to compute debt sustainability, should be made public to allow an informed debate.
- ✓ The ESM should publish redacted minutes of its Board of Directors and Board of Governors meetings.

ACCOUNTABILITY

- ✓ The ESM should be integrated into the EU Treaties as soon as possible, embedding it into the EU's wider accountability framework with a whole range of EU bodies and institutions. Today, the ESM operates as a purely intergovernmental organisation under public international law.
- ✓ The ESM should conclude a formal agreement of cooperation with the European Parliament that would establish an appropriate interim mechanism to increase its accountability at the European level.
- ✓ National parliaments should hold hearings with their national finance ministers, before and/or after each meeting of the ESM's Board of Governors. ESM decisions should not be taken in the Eurogroup.
- ✓ The ESM should have an internal, independent evaluation office, modelled after the International Monetary Fund's example.

INTEGRITY

- ✓ Institutional independence of the ESM Board of Governors vis-à-vis the Eurogroup should be strengthened. The independence of the Board of Directors from the Board of Governors should be ensured via irrevocable appointments of the Directors by groups of countries.
- ✓ The ESM's Code of Conduct should apply to all external collaborators and should be strengthened to avoid conflicts of interest. This includes affirming prohibitions regarding direct investments, trades or sales of financial instruments defined under the Code of Conduct.
- ✓ The Managing Director should be obliged to file public declarations of financial interests. A voluntary practice is not sufficient.
- ✓ The ESM should more clearly advertise its “Whistleblowing Procedure”, including a dedicated interface for external consultants and citizens wishing to report irregularities to the ESM.

BACKGROUND

The ESM is the Eurozone's "bailout fund", providing liquidity to governments that can no longer finance themselves on bond markets. This section recalls its creation during the euro crisis, its effect on lending conditions, and current proposals for reform.

THE EUROZONE'S ECONOMIC GOVERNANCE

The EU's Economic and Monetary Union (EMU) is set to undergo further reforms over the coming years. At Transparency International EU we will accompany this process through a dedicated project looking into the transparency and democratic accountability of EU economic governance. Find out more under www.transparency.eu/euro

The euro crisis led to a series of rushed reforms and created new institutions such as the European Stability Mechanism (ESM). In terms of the coordination of Eurozone budgetary and economic policy, the blurred division of competences between Member States and the European level continues, resulting in rules that are too complicated to understand, even for experts. This muddies the decision-making process and confuses where the accountability for decisions lies.

At Transparency International EU we believe in the need for democratic accountability of the institutions that govern us, necessitating much greater transparency. That includes political institutions such as the European Parliament, European Commission and the Council of Ministers or economic governance

bodies, such as the European Central Bank or the ESM.

Transparency, accountability and integrity are vital to ensure that economic governance works for us all and not just for the most powerful countries, or other vested interests, e.g. the interests of European banks holding Greek debt in the lead-up to the Greek sovereign debt crisis of 2010. Civil society, academics, citizens and the media need to be able to monitor how decisions that affect us all are made.

That is why we have launched a project on EU economic governance to accompany the EU's efforts to design an economically sustainable and democratically legitimate euro. We have to make sure that democratic accountability is more than just an afterthought.

The first report in this series was launched in November 2016 and focuses on the European Investment Bank (EIB) and its delivery of the Juncker investment fund, 'Investing in Integrity? Transparency and accountability at the EIB. Read it here: www.transparency.eu/investing-in-integrity

The European Stability Mechanism (ESM) is an intergovernmental institution established in 2012 to act as a permanent financial assistance fund for the Member States of the Eurozone.¹ As such, it can mobilise funding up to a limit of €704.8 billion, with a lending capacity capped at €500 billion, to provide stability support to the benefit of contracting Member States that are experiencing, or are threatened by, severe financing problems. This support is granted under strict conditionality. According to its founding treaty, the ESM intervenes if its financial assistance is judged to be indispensable to safeguard the financial stability of the euro area as a whole and of its Member States.²

The origins of the ESM and its predecessor³ reflect a compromise between the institutional constraints posed by the EU founding treaties, which are difficult to amend, and the domestic political environment in euro area Member States. Institutionally, the ESM is a 'Catch-22': it is a policy instrument intended to provide 'bail-outs', in the context of the EU founding treaties that prevent bail-outs. Article 125(1) of the Treaty on the Functioning of the European Union (TFEU) states that the Union cannot be made liable for Member States that cannot honour their payments. The logic is that Member States are not obliged to provide assistance to other members, in order to prevent moral hazard. However, the costs of a Member State

becoming insolvent and defaulting on their obligations include not only economic turbulence for the whole region but also the risk of a Eurozone breakup.⁴ When the crisis hit, the EU needed a mechanism to provide stability funding to members while not violating the treaty. In 2010 the EU institutions created the European Financial Stabilisation Mechanism (EFSM), based on the (limited) EU budget.⁵ An intergovernmental agreement was then created outside the treaties in the form of the European Financial Stability Facility (EFSF), the ESM's predecessor, which continues to exist alongside the ESM and is issuing new bonds for as late as 2043.⁶

The initial mission of the EFSF was to address the wider contagion of the sovereign debt crisis from Greece to other euro area Member States such as Ireland, Portugal, Spain and Italy.⁷ The first international intervention – jointly organised by the Eurozone Member States and the International Monetary Fund (IMF) – began in May 2010. This was at the request of the Greek government, setting up the Greek Loan Facility (GLF),⁸ which consisted of bilateral loans from euro area countries. Shortly before this, the European Council had launched the EFSM. A financial assistance mechanism under EU law, the EFSM was tasked with leveraging EU budget funds on financial markets in order to provide financial assistance to the Greek government. Jointly, the GLF and to a lesser degree the EFSM were tasked with reducing the country's foreign debt and giving Greece the time needed to restore the country's access to private sovereign bond markets. In June 2010, the euro area Member States established the EFSF as a public company under Luxembourg law,⁹ as a financial assistance instrument that was intended to deliver the additional financial fire-power needed to stop 'contagion', i.e. the risk that Greece's financial troubles would translate into drastically higher interest payments for other peripheral economies. These temporary sovereign bond market assistance funds were replaced in 2012 with the permanent ESM.¹⁰

The ESM's founding document is the ESM Treaty, which entered into force on 27 September 2012. It should be understood as a treaty under public international law, between the euro area Member States. It is situated outside the EU legal framework, given that "the Member States did not — and according to the CJEU were not permitted to — utilize the enhanced cooperation provisions of the Treaties in its adoption."¹¹ The European Parliament,¹² the Court of Justice of the EU (CJEU) in the Pringle case, as well as national constitutional courts in Estonia and Germany, have confirmed this interpretation of the status of the ESM Treaty.

At the same time, the establishment of the ESM was eased by the addition, in March 2011, of a third paragraph in Art. 136 TFEU, clarifying the euro area Member States' right to establish a financial stability mechanism. The treaty amendment was designed to avoid the need for referendums, and was introduced using the simplified revision procedure foreseen since the Treaty of Lisbon, with the consent of all 27 EU Member States (at the time) and the European Parliament:

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.

– New Art. 136(3) TFEU

Over time, the EFSF and ESM have emerged as large players in the euro area sovereign bond market, with outstanding bond volumes similar to that of a small euro area economy. Together, they have disbursed €264.8 billion as of February 2017. Research suggests that the sovereign bond markets trusted the guarantee structure of the EFSF, treated it as a core issuer of bonds and consequently reattached the periphery to the core, relegating Greece to a "special case" area of high risk.¹³

The scope of the ESM interventions includes six funding instruments. These are: direct loans (the most used with Greece, Portugal and Ireland); primary and secondary market purchases (developed but never used); precautionary programmes à la IMF (developed but not used); as well as direct and indirect bank recapitalisation assistance (the latter was used for Spain). These interventions are financed by the issuance of bonds and other debt instruments on the capital market. In short, the ESM emerged as a lender of last resort for euro area sovereigns facing serious bond market pressures.

Table 1: ESM funding instruments	
Stability support loan	Direct loan from the ESM to an ESM member
Primary market support facility	Allows the ESM to participate in bond markets, buying bonds directly from the supported government, in auctions designed for private financial market participants.
Secondary market support facility	This works like the primary market support facility, but allows the ESM to purchase government bonds indirectly, on the secondary market, off other holders of the bonds.
Financial assistance for recapitalisation of financial institutions ('indirect recapitalisation')	A tool for crises due to a member's financial sector, with conditionality refocused accordingly. This was the instrument used in Spain.
Direct recapitalisation instrument (DRI)	An instrument to directly recapitalise banks, under highly specific and restrictive conditions, after all other instruments, including 'bail-in' and the Single Resolution Fund, have already been used. This instrument backs up the EU's Banking Union.
ESM precautionary financial assistance	Allows Member States to secure ESM financial assistance before incurring unsustainable refinancing conditions on financial markets. Conditionality is lighter and monitored via 'enhanced surveillance' by the Commission, rather than a full ESM macro-economic adjustment programme.

The ESM's Managing Director is also the EFSF Chief Executive Officer and the two institutions are operationally, albeit not legally, identical. The EFSF is a *pari passu* ("equal footing") creditor that was incorporated as a public limited liability company under Luxembourg law. The EFSF's first bond issue was one of the largest on record at €5 billion, and was nine times oversubscribed, meaning demand for the bonds far outstripped the amount on offer.¹⁴

In contrast, the ESM is a permanent intergovernmental institution under public international law that can claim a preferred creditor status (after the IMF).¹⁵ The EFSF is backed by the guarantees of the euro area Member States¹⁶ while the ESM is backed by the subscribed capital of €704.8 billion, including the €80.5 billion in paid in capital of the Eurozone Member States. Both are financial assistance funds but the maximum lending capacity of the ESM is larger (€500 billion) compared to that of the EFSF. In 2011, the Eurozone increased the size of the EFSF from a lending capacity of €225 billion to a full €440 billion, by upping the guarantees from participating EU countries. However, the EFSF no longer grants new stability support beyond its outstanding loans, amounting to €174.6 billion in total.

The ESM's structure, on the other hand, is based on paid-in capital that the ESM physically holds and invests, and callable capital contributions, which Member States have committed to the tune of pre-set amounts. This distinguishes the ESM from the EFSF's reliance on guarantees. It means that credit rating downgrades of its main suppliers of callable capital can indirectly lead to downgrades for the ESM. Thus, in 2012, a downgrade of France led to a downgrade of the ESM (from AAA to Aa1). As the downgrading agency put it:

the credit strength of the ESM rests in part on its certainty of being able to call on its members to fulfil their callable capital commitments (...) In the very unlikely event of France being unable to fulfil its obligations to the ESM, there is a reasonable probability that other non-AAA supporters would not be able to do so either. Accordingly, the deterioration in the creditworthiness of France as the second-largest euro area member state (as reflected by the recent downgrade), which implies a marginally diminished certainty it would be able to provide support to the ESM, in 2012 negatively affected ESM's creditworthiness.¹⁷

Further downgrades in France's credit rating have not had the same effect, and the ESM takes pride in pointing out that its credit rating was still Aa1 by Moody's and AAA by Fitch, as of 2016.¹⁸

The EFSF and ESM interventions in the Eurozone sovereign bond markets and the European Central Bank's role after its President Mario Draghi's declaration it would do "whatever it takes" to save the euro can be credited with the first successful attempt to arrest a systemic sovereign bond market crisis in the

Eurozone (Figure 1). Indeed, the fact that the European Central Bank (ECB) and EFSF/ESM acted in tandem was critical for this success.²¹ At the height of the crisis, in 2012, funding was insufficient to address all critical needs in the Eurozone, with emergency funds for Greece, Ireland, and Portugal in play, while Italy and Spain wobbled without dedicated support.²² All in all, today, four of the five countries that received ESM assistance can borrow at sustainable rates and have exited their programmes.

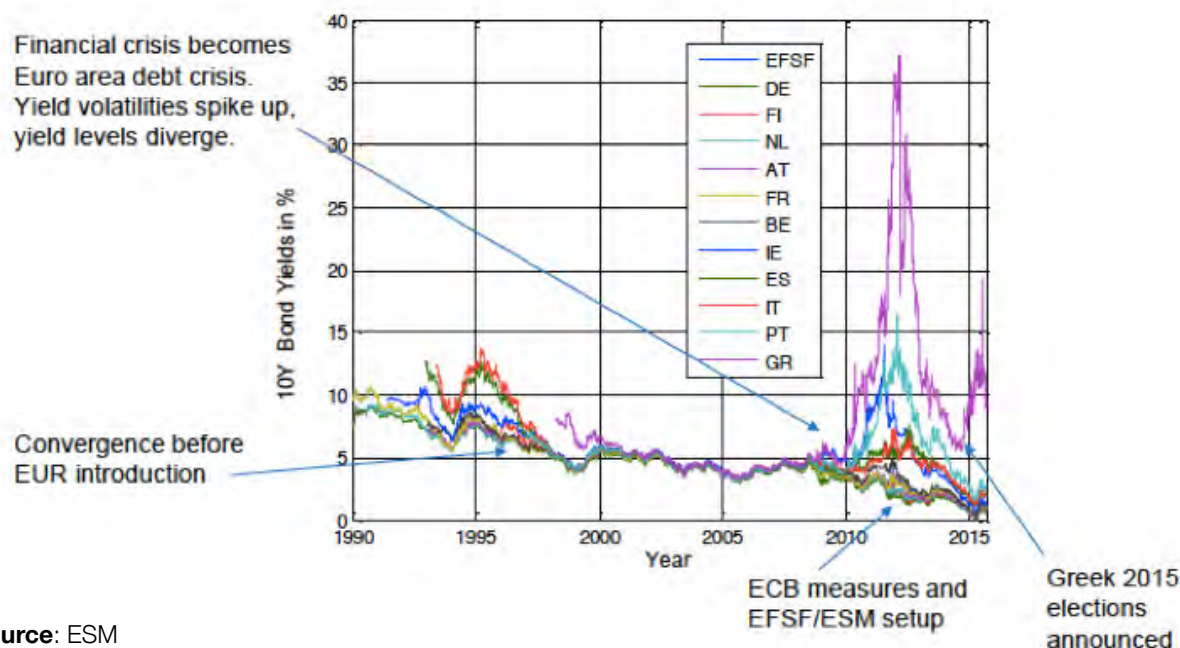
Table 2: ESM capital structure

Authorised capital stock	€704.8bn
– Paid-in capital	– €80.5bn
– Committed callable capital	– €624.3bn
Maximum lending capacity	€500bn
Remaining ESM lending capacity	€363bn
Greek government debt as of 2016 ¹⁹	
– Nominal	– €323.7bn
– As percentage of GDP	– 176.9 %
Italian government debt as of 2016 ²⁰	
– Nominal	– €2,217.70bn
– As percentage of GDP	– 132.7 %



The signing ceremony of the ESM Treaty

Figure 1: Select sovereign bond yields at critical junctures of the crisis



Source: ESM

Indeed, faced with ongoing bond market panic, the ESM showed flexibility in its lending practices. It abandoned the EFSF's initial and stricter, high margin, relatively short maturity (5-12 years) IMF-style sovereign lending paradigm used mostly in Ireland and Spain and transitioned instead to a low-margin, long-maturity one (32 years) that greatly facilitates the repayment for the programme country concerned. The Financial Times cited private sector evaluations showing how drastic the consequences of this change were. Relying on long-term maturity allows a much slower cycle of debt refinancing, meaning that Greece has to raise fewer funds in the coming decades in order to refinance bonds that have to be repaid. When calculating the repayment risk on a given bond, investors will not focus on the overall stock of outstanding debt. Rather, they will need to know how much of the debt needs to be repaid within the time-frame of the bond whose risk investors are seeking to assess, i.e. a focus on flows. If this methodology were applied to the case of Greece, it would lead to an estimation of "gross balance sheet debt of €118bn at the end of 2015 (67 per cent of GDP), rather than €314bn (178 per cent of GDP) as reported by the International Monetary Fund (IMF) or €311bn as reported by Eurostat. Almost all of this roughly €200bn in debt reduction had occurred by the end of 2012." Further lending to Greece by the ESM reduced Greece's balance sheet debt by another €17 billion. The changes in lending terms "effectively reduced the Greek government debt burden by about 49 per cent of the country's 2013 output, or about €88bn."²³

These dramatic changes in the Greek outlook show the relevance of methodological tweaks and lending terms. At the same time, the ESM's strong exposure to Greek sovereign debt gives it a very distinctive outlook as a lender, making it directly vulnerable to the sustainability of Greece's debt.

PROPOSALS FOR REFORM: THE FIVE PRESIDENTS' REPORT

The proposition of incorporating the ESM into the EU treaty framework has received wide-spread support from the President of the European Commission Jean-Claude Juncker, European Council President Donald Tusk, Eurogroup President Jeroen Dijsselbloem, ECB President Mario Draghi and then-European Parliament President Martin Schulz in the form of the Five Presidents' Report of June 2015.

This document constitutes the main framework for the reform and deepening of EU economic governance. Authored by the head of the Commission "in close cooperation with" the heads of the European Council, ECB, Eurogroup and the European Parliament, the future of the ESM is discussed under the rubric of integrating intergovernmental solutions within the EU legal framework. After noting that the Treaty on Stability, Coordination and Governance already foresees this development, with specific reference to the ESM, the report notes that "largely as a result of its intergovernmental structure, its governance and decision-making processes are complex and lengthy in the medium term (Stage 2), its governance



should therefore be fully integrated within the EU Treaties” (p. 18). This reform is envisaged inter alia to contribute to the Political Union’s objectives of democratic accountability, legitimacy and institutional strengthening (p. 21).

There are no remarks for turning the ESM into a fiscal stabilisation fund. The establishment of such a fund is indeed envisaged, but for a future structure based on the European Fund for Strategic Investments (EFSI, the so-called Juncker investment fund run jointly by the Commission and the European Investment Bank).²⁴ Based on the idea that “all mature Monetary Unions have put in place a common macro-economic stabilisation function to better deal with shocks that cannot be managed at the national level alone” (p.14), such a prospective stabilisation function could build on the EFSI as a first step “to prevent crises and actually make future interventions by the ESM less likely” (p.15). However, the presidents were keen to clarify that such a fund should not be used as a Keynesian instrument that could be tapped “to actively fine-tune the economic cycle at euro area level” but as a simple lender tasked with the “cushioning of large macroeconomic shocks” (p.14) that fall short of sovereign debt crisis situations such as those that the ESM is tasked to deal with.

Other proposals for ESM reform suggest the creation of a ‘European Monetary Fund’ modelled after the IMF, which would integrate within the ESM the functions currently shared between the Troika institutions (negotiating, implementing and monitoring financial assistance conditionality).²⁵ Giving the ESM a greater say over the programme reviews would need to come hand in hand with far greater accountability than is currently the case. The ESM’s Director also hopes for such a development.²⁶

The European Parliament stressed that the CJEU Pringle case-law (see Greek case study below) and jurisprudence opens up the possibility of bringing the ESM into the EU Treaty framework on the basis of Article 352 TFEU and called on the Commission to put forward, by the end of 2014, a legislative proposal with that objective.²⁷

✓ **Future treaty changes should integrate the ESM into the EU’s legal framework.**

The analysis provided by this report makes several suggestions for further improvement of the ESM integrity system. The suggestions include both ESM Treaty changes that are outside the purview of the ESM itself as well as changes that can be implemented by ESM senior management.

INDEPENDENCE IN LAW

The ESM's independence is very limited: it is an extension of the Eurozone's finance ministries, which control both of its governing bodies. Still, its consensus-based approach ensures Member States cannot steer ESM policy on their own. An emergency procedure exists to avoid the blockade of the ESM's functioning, however, Germany, France and Italy retain a de-facto veto.

The independence of the ESM as an organisation, or of its governing bodies, is covered in several provisions of the ESM Treaty.

First, the ESM has full legal personality, allowing it to enter into a direct legal relationship with the stakeholders needed to deliver its mission, i.e. sovereign and private sector financial market participants.²⁸ Second, its archives, documents and premises of the ESM are considered inviolable, enjoying diplomatic protection from its host state, Luxembourg.²⁹ Third, the members of Board of Governors, the Board of Directors, the Managing Director (MD) and other staff members "shall be immune from legal proceedings with respect to acts performed by them in their official capacity and shall enjoy inviolability in respect of their official papers and documents."³⁰ This is standard practice for organisations under international public law, to prevent undue influence from the host state – this also applies to EU institutions, bodies and agencies.³¹ Finally, the ESM is also exempted from any requirement to be authorised or licensed as a credit institution.³²

ESM GOVERNING BODIES

Overall, the ESM's main governing bodies are little more than an extension of the finance ministries of the Eurozone Member States, i.e. the same Member States represented in the Eurogroup. As such, this is a classic shareholder-controlled body. The highest decision-making body of the ESM is the Board of Governors (BoG), composed of the Ministers of Finance of the 19 euro area Member States.³³ Its membership is therefore identical with that of the Eurogroup.³⁴

The BoG's independence vis-à-vis other EU bodies and international financial institutions is better safeguarded: The European Commission, the ECB and the Eurogroup president (if he or she is not already the chairperson or a governor) may only attend the meetings of the BoG as non-voting observers.³⁵ The IMF representatives and the representatives of non-participating Member States also have the possibility of attending BoG meetings, but only on an ad hoc basis, at the invitation of the BoG.³⁶

The roles and arrangements of the governing bodies of the ESM are clearly defined in theory, although the overlap with the Eurogroup can blur responsibilities in practice (see Independence in Practice). The BoG makes the most important and politically-sensitive decisions, which must be adopted with the unanimity of the members participating in the vote provided that at least 13 ESM members are present. The BoG is the sole body of the ESM that can issue additional shares, change the authorised capital stock and adapt the maximum lending volume.

Critically, the BoG signs off on the provision of stability support to Member States in need and chooses the instruments and the terms under which this support is provided. The BoG gives a mandate to the European Commission to negotiate the Memoranda of Understanding with the assisted state, in liaison with the ECB, meaning the EU institutions are acting on behalf of the ESM. Finally, mutual agreement is also necessary to change the spectrum of financial instruments of the ESM and the ways in which the EFSF's temporary support gets transferred to the ESM over time.

Compared to the IMF's BoG, which only meets twice a year and delegates most of its competences vis-à-vis lending decisions to the resident Executive Board, the ESM's BoG remains a hands-on governing body, making the ESM more tightly controlled by euro area Member States. The BoG's structure itself and its competences regarding the financing instruments at the ESM's disposal are similar to those of the IMF's own BoG, which is comprised of finance ministers or central bank heads of each of the 189 member states. It votes on quota increases, shareholder structure, member admittance and withdrawal, and amendments to IMF Articles of Agreements and By-Laws. This body meets twice a year, at the autumn Annual Meetings and Spring Meetings, and the majority of its business is allocated to the International Monetary and Financial Committee (formerly the Interim Committee).

Less far-reaching decisions can be adopted with a qualified majority (80 per cent of the votes cast by the governors). These include the terms of accession to the ESM by new Eurozone Member States, changes in By-Laws and Rules of Procedure, annual accounts approval, debt recovery from debtor states, the appointment of the MD and the Board of Auditors. The Board of Governors, in line with Article 19 ESM Treaty, can review the list of financial assistance instruments, and amend it. By way of example, the BoG has played an important role regarding the other side of ESM lending to date: The Direct Recapitalisation Instrument, which allows the ESM to lend directly to banks based in Member States experiencing financial difficulties.³⁷

The Board of Directors (BoD) is the directing body of the ESM. The BoD members are appointed by BoG from “persons of high competence in economic and financial matters”. In practice, BoD members are appointed from the ranks of the finance ministries of the Member States (usually state secretaries or high-ranking officials) and, for this reason, the Board strongly reflects the composition of the BoG. Each governor appoints one director and one alternate director, with the Commission and the ECB having the right to sit in on BoD meetings as observers. There are no provisions related to the independence of the members of BoD, and the appointments to the Board are revocable at any time, making this another governing body directly controlled by the Member States, ensuring direct de-central accountability (see sections on Accountability) at the expense of institutional independence.³⁸ Comparing this with the situation at the BoD’s counterpart at the IMF, the Executive Board, its appointments are irrevocable for the duration of their term and its members represent clusters of countries rather than individual ones, making the representatives less vulnerable to domestic political influence and affording them greater discretion by preventing direct control by one state or another.³⁹

The most important decisions of the BoD also require unanimous support of the directors and refer to three categories of questions: Should a credit line be maintained? Should loan or bank recapitalisation tranches that are subsequent to the first tranche be disbursed? In contrast, qualified majority is demanded for and ESM-internal human resources and budgetary issues.

The ESM BoD is certainly more representative than its peer institution: on the 24-member Executive Board of the IMF, eight appointed executive directors currently represent individual countries with the largest quotas (the United States, Germany, France, the United Kingdom, Japan, China, Russia and Saudi Arabia), with 16 executive directors representing the other 181 members.

The MD is appointed by the Board of Governors and has to be a national from an ESM Member State. There is no rotation scheme and no restrictions for debtor countries among the Member States as regards the appointment of the MD. While the global peer institution, the IMF, has customarily had an MD from Europe, the MD at the IMF’s European counterpart has so far always come from Germany, for both the EFSF and the ESM. Klaus Regling was appointed to serve as ESM MD for a five-year term at the ESM’s inception in July 2012, and signalled his availability for a second term beginning end-2017. After receiving an endorsement by his compatriot Mr Schäuble, the German member of the ESM BoG,⁴⁰ he was re-appointed for a second term, due to start on 8 October 2017, over six months ahead of schedule, on 20 February 2017.⁴¹ However, given the ESM’s short history it would be mere speculation to see an emerging tradition to give the MD to the largest creditor country.

The MD is assisted by the Management Board and plays a critical role in the day-to-day activities of the ESM. The duties of this office include chairing the meetings of the Board of Directors and serving as the legal representative of the ESM and the chief of staff of the ESM.⁴² The Management Board controls four specialised committees: corporate projects, investment management (how to invest shareholders’ paid-in capital), finance and internal risk.

Again, the ESM compares favourably with IMF. At the Fund, the MD is appointed by the Executive Board, which, as indicated above, has a clearer tilt in favour of the largest shareholders.

Figure 2: The current members of the ESM Management Board



Klaus Regling
Managing Director



Christophe Frankel
Deputy Managing Director
and CFO



Kalin Anev Janse
Funding, Asset Liability Management
& Lending and Secretary General



Françoise Blondeel
Middle and Back
Office & Coordination



Rolf Strauch
Economics, Policy Strategy
and Banking

Finally, the Board of Auditors (BoA) performs the internal oversight function of the ESM. Its mandate consists of inspecting the ESM accounts, performing independent audits and monitoring internal and external audit processes. For the EFSF, the Audit Committee is composed of five members of the BoD, in line with Luxembourg legal requirements. In the performance of these duties the BoA has full access to any ESM documents and information. The five-member BoA has more satisfactory independence protections: two of its members are appointed upon a proposal of the supreme audit institutions (SAI) of two ESM Member States on a system of rotation, two upon the proposal of the chairperson of the BoG and one upon the proposal of the European Court of Auditors (ECA). The members of the Board of Auditors are explicitly declared independent and report to the Board of Governors.⁴³ The members serve for a three-year term, which is non-renewable.⁴⁴

In terms of peer comparisons, the ESM could learn from the experience of the IMF with its own Internal Evaluation Office. This body was established in 2001, and its independence and sharply critical reports have played a useful role in helping the Fund deal with challenges to its legitimacy,⁴⁵ particularly in times of diverging views among economists on subjects such as fiscal multipliers and the extent to which assumptions made in economic models still apply in crisis times. The Internal Evaluation Office is fully independent from IMF management and operates at arm's length from the Executive Board, although the Board appoints its director. As one observer of the IMF noted:

Independent evaluation is intended to steepen the Fund's 'organizational learning curve' through the provision of candid assessments

on what has or has not worked in the past and by reducing information asymmetries to facilitate greater oversight and accountability, primarily by the Fund's Board of Executive Directors, but also by internal management as well as external principals and watchdog organizations.⁴⁶

✓ **The ESM should establish an evaluations office with sufficient independence to provide critical and public assessments of ESM practices.**

EMERGENCY PROCEDURE

Unlike the EFSF, the ESM also has an emergency procedure under which assistance may be granted if there is a favourable qualified majority of at least 85 per cent of the votes cast in the BoG, under specific conditions. To trigger this mechanism, in effect circumventing the unanimity requirement and potentially exposing ESM Member States to losses without requiring their acquiescence, the European Commission and ECB both have to conclude that "failure to urgently adopt a decision to grant or implement financial assistance (...) would threaten the economic and financial sustainability of the euro area".⁴⁷ When an ESM Member requests stability support from the ESM, the chairperson of the Board of Governors entrusts the European Commission, in liaison with the ECB, to assess the actual and potential financing needs.⁴⁸ Based on their assessment, the BoG may decide to grant stability support or not. To date, it always has granted the support requested.

INDEPENDENCE IN PRACTICE

In practice, the ESM has carved out a space for itself: its Member States have more direct control over the ESM than they do over the Commission, enabling governments to keep a tight leash on reforms in “bailout” countries. The ESM’s reach has been increasing beyond the mere provision of funding, but it has become more difficult to distinguish the ESM from the Eurogroup, an informal club of euro area finance ministers.

The ESM is an institution controlled by its shareholders. Its access to financial markets hinges on shareholders’ credibility and credit rating, as shareholders have to make up for any losses that the ESM may incur in the event of a sovereign default, if the losses exceed the €80 billion paid-in capital, or to replenish the capital stock after incurring losses. In exchange for this risk, its Member States appear to favour a tight grip over the ESM, as reflected in ESM governing bodies that are directly controlled by Member State representatives.

MISSION CREEP

In practice, this has led to the emergence of the ESM as a new actor in the negotiations leading up to and accompanying the implementation of financial assistance programmes. At the beginning of the Eurozone’s sovereign debt crisis in 2010, euro area countries had entrusted the Commission with overseeing the conditions attached to financial assistance, in the knowledge of the discretion required to judge whether reforms had been implemented to a satisfactory degree. Even in this specific context, where the Commission is acting on behalf of the ESM, and therefore not on behalf of the EU as a whole, it is a significantly more independent institution with a decades-old and entrenched duty to pursue the European interest as defined at the supranational level, which can differ significantly from the European interest as defined in intergovernmental negotiations.⁴⁹ Negotiations between governments intent on pursuing their national interests will depend on negotiating dynamics, and in particular exacerbate mismatches in the political power of ‘creditor’ countries on the one hand and ‘debtor’ countries on the other.

From the outset, some Member States expressed concern that the Commission may go ‘soft’ on the programme countries, leading Germany in particular to insist on the deep involvement of the IMF in the surveillance missions accompanying the programmes,⁵⁰ given its longstanding experience. Alongside the ECB, which is asked to join the missions on account of its expertise in euro area economic developments and its responsibility for the currency area’s monetary policy, these three institutions formed

the so-called ‘Troika’.

It quickly became apparent that the ESM would play a stronger role in the Troika than the temporary EFSF had until that point. The legal anchoring for this are the strengthened role of the ESM for the programme proposal and the ESM’s “Early Warning System”, which is based on Art. 13(6) ESM Treaty. The system is intended to alert the ESM of repayment risks on the part of the debtor countries.⁵¹ In practice it is combined with the Commission’s bi-annual post-programme surveillance missions for former programme countries, and with the review missions in the case of ongoing programmes.

No such provision existed for the EFSF, suggesting the ESM’s Early Warning System is relevant only for Spain, Greece and Cyprus. However, in December 2013, the Eurozone’s Member States decided to extend it to the previous EFSF programmes, providing an opening for the ESM to participate in the post-programme surveillance (PPS) in Portugal and Ireland. Henceforth, all PPS reports contain the same sentence: “The ESM participated in the meetings on aspects related to its own Early Warning System”,⁵² excluding the ESM from all aspects of the surveillance mission that do not pertain to debt repayment. As evidence of this, we note that programme reviews relating to Greece’s second financial assistance programme running until the end of 2014 and based on EFSF funding did not make reference to the presence of ESM or EFSF staff in the Troika’s missions to Greece.⁵³ This reflects the practice with the EFSF: the ‘bailout’ fund limits itself to the provision of liquidity, while the Troika assesses the implementation of programme conditionality.

This changed with the third Greek programme, the first one for Greece since the entry into force of the ESM Treaty. The programme review document is still prepared by the Commission “in liaison with the ECB”, with no mention of the ESM. However, the reports now note that the Commission’s monthly missions to Athens were undertaken “together with” staff of the ECB, IMF and now also the ESM,⁵⁴ leading to the new informal term, the ‘Quadriga’. The ESM justifies the need to be present at technical discussions in the programme countries with its large exposure to the country’s debt:



Eurogroup press conference, from left to right: Christine Lagarde, IMF Managing Director; Pierre Moscovici, European Commissioner for Economic and Financial Affairs, Taxation and Customs; Jeroen Dijsselbloem, President of the Eurogroup and Chair of the ESM Board of Governors; and Klaus Regling, ESM Managing Director



in the case of Greece, the ESM/EFSF have long been the largest single creditor,⁵⁵ making it vulnerable should Greece be unable to refinance its debt.

At the same time, the ESM's governance clearly affords Member States more direct access to the technical deliberations of the Troika/Quadrige surveillance of programme countries, as compared to their indirect representation via the Commission. Coupled with the identical setup between the Eurogroup and the ESM's BoG, this may translate into a higher degree of control, by the Member States, over the execution of financial assistance, as compared to the influence held by Member States when represented more indirectly by the European Commission.

The creation of new European institutions should be designed so as to advance the Union's ability to govern the Eurozone. It could be questioned whether cementing the intergovernmental approach contributes to a shared sense of ownership in the Eurozone, or may on the contrary contribute to the division of the Eurozone into 'creditors' and 'debtors'. To the extent that it strengthens the informal and intergovernmental Eurogroup rather than the EU's economic governance institutions, the setting up of the ESM outside of the treaties can be described as a lost opportunity.

AN EFFECTIVE EMERGENCY PROCEDURE?

There is a clear trade-off between the current, decentralised accountability architecture and the ESM's ability to act. The unanimity requirement guards Member States against the risk of losses, but in combination with the need in some countries to also secure approval from their national parliaments, a successful outcome is not guaranteed. The Slovakian parliament, for example, could have used its veto to block the expansion of the EFSF's lending firepower, although it did not follow through on the threat. There is a danger here that national parliaments are involved in adding extraordinary conditions, calls for information and guarantees from Member States receiving ESM funds – even while notionally increasing democratic accountability. A systematic coding of national parliamentary votes for the EFSF reveals important political risks if an action by the ESM required national parliaments' approval. The main finding is that “governing parties did not make appeals for solidarity among Member States, but rather to their national economic interests and the sustainability of the Eurozone system as such.”⁵⁶

Such a blockade of the ESM's functioning can be overcome if a state's financial difficulties pose a

threat to the currency area as a whole, triggering the emergency voting procedure. However, some shareholders are more equal than others. Only 85 per cent of the BoG votes cast are required to green-light financial assistance in those cases. This means that Germany, France and Italy, which hold more than 15 per cent of ESM shares, can on their own veto the financial assistance even if the European Commission and the ECB jointly deem it essential to the survival of the single currency. In other words: The requisite qualified 85 per cent majority of votes “already can be achieved on the basis of the decision of the six largest Member States⁵⁷ [provided that a quorum is present]. In other words, six Member States can make decisions without needing the ‘pro votes’ of the remaining eleven Member States (...) the decision-making process of the ESM has been shaped such that Germany with its 27% share has been attributed the right of veto on all payments, which it does not hold under the EU qualified majority voting rules”.⁵⁸

INDEPENDENCE FROM THE EUROGROUP

Overall there is no clear gap between law and practice in the activities of the ESM governance and oversight bodies. That said, there is evidence of a tendency to conflate the ESM's governing bodies with its Member States. This practice is most evident with the interchangeable nature of the ESM BoG and the Eurogroup, whose membership and chairmanship is identical. The picture is further complicated by the fact that the Eurogroup, which is described as an informal consultative body, in practice prepares (and also takes) decisions on behalf of the Eurozone, which are later formally adopted by the Council of the EU (in its ECOFIN formation, where all EU finance ministers are represented). Formally speaking, the Eurogroup cannot take decisions,⁵⁹ while the ESM BoG escapes the framework of the EU treaties.

Our interviewees at the ESM confirmed that the collective will of the BoG is already formed in the Eurogroup before the BoG takes its formal decisions, noting that, at Board meetings, “discussions are not very long, because it is an implementation of the decision of the Eurogroup, this is how it works in practice”. The fact that the Eurogroup is an informal political body for consultations among the ministers of finance of the euro area, and not a decision-making body, makes this institutional arrangement even less transparent. In writing, the ESM later noted:

The notion that the collective will of the Board of Governors is formed in the Eurogroup does not reflect ESM's view. The ESM is controlled by its governing bodies, which

are not dependent on or accountable to the Eurogroup. The fact that there are consensus-building instances among shareholders outside of the ESM governing framework does not override the ultimate control of the governing bodies over the ESM.

However, the Chairman of the ESM's BoG Jeroen Dijsselbloem provides further evidence of the hollowing out of the ESM governing bodies when he writes that "ESM governing bodies typically convene once the relevant national procedures, which commence after the Eurogroup has reached a political understanding, have run their course". This justifies why ESM programme documentation will, as of June 2016, be published before ESM BoG meetings, but may only be published after the meetings of the Eurogroup.⁶⁰

The Eurogroup itself has an unclear accountability relationship to their electorates, as soon as national finance ministers are asked to take decisions on the Eurozone as a whole, with no transparency on how decisions are taken and what trade-offs compelled ministers to fall into line behind the outcome. Comparing this situation with that of the IMF, the ministers of finance voting in the BoG are not part of any informal body that comes to the table with a ready-made decision. Moreover, as we have seen, the IMF's BoG only meets twice a year and exercises less control over the Fund.

One avenue for avoiding this institutional conflation would be for each Member State to designate by parliamentary vote a governor other than the national minister of finance who would not be institutionally subordinated to that minister.

CASE STUDY 1: The Greek programmes between legality and legitimacy

Greece is undoubtedly the most salient case of the European sovereign debt crisis. Not only was this the first case of a balance of payments crisis within the Eurozone, it is also the only state that has not “graduated” from international assistance, after seven years of reform programmes. While legal in the EU context, the institutional arrangement in which the ESM is embedded runs low on popular legitimacy (both in debtor and creditor countries) and may be controversial from the perspective of a strict interpretation of human rights law. A recent spat between the Europeans and the IMF highlighted a lack of transparency on economic models and assumptions made.

ESM LEGAL STATUS

The ESM's legal arrangement was challenged in the European Court of Justice almost as soon as it was established. Thomas Pringle, an Irish national, asked Irish courts to clarify if the ESM Treaty was compatible with the Irish constitution and whether a referendum was not required to validate Ireland's ratification. Critically, Mr Pringle argued that the Troika conditionality could have an adverse effect on the rights guaranteed by the EU Charter of Fundamental Rights. This document was adopted in 2000 and guarantees a broad array of rights and freedoms under six titles (Dignity, Freedoms, Equality, Solidarity, Citizens' Rights and Justice). With the entry into Force of the Treaty of Lisbon in 2009, it is legally binding on the institutions and bodies of the EU as well as on national authorities when they are implementing EU law.

The Irish High and Supreme Courts rejected the claim but asked CJEU for clarifications regarding the legal status of the ESM: (1) whether the Council's amendment to Article 136 TFEU to include a reference to a stability mechanism was legal, and (2) whether the ESM Treaty itself was not in fact incompatible with the existing EU Treaties.

On 27 November 2012, the Court ruled that: (1) the establishment of the ESM was procedurally and substantively legal; that (2) the ESM is not an EU body; and (3) the Member States were not implementing Union law when they established the ESM. Therefore, the European Court decided that the EU Charter of Fundamental Rights is not applicable to the ESM and the Member States acting in the ESM. This interpretation was based on article 51(1) of TFEU requiring EU Member States to observe the Charter “only when implementing EU law”.

However, the Court did not state that the Commission and the ECB are not bound by the Charter. Indeed, unlike the Member States, Article 51 TFEU clearly states that the EU institutions are indeed bound by the Charter without specifying any conditions, meaning that they are bound even when acting outside of the EU law framework, such as when they act on behalf of the ESM within the Troika or the Quadriga. As one legal scholar put it, “there is no basis upon which to conclude that fundamental rights and obligations can be circumvented on the pretext of a delegation of functions”.⁶¹ This view is widely shared among leading legal scholars⁶² and, as such, it questions the accountability of the ESM to European citizens whose social rights are negatively affected by the conditionality imposed as part of the ‘bailout’ agreements. This is because Article 13(3) of the ESM Treaty stipulates that the BoG delegates to the EC in liaison with the ECB to negotiate and monitor compliance with, on behalf of the ESM, an agreement (Memorandum of Understanding, or MoU) with the ESM member requesting assistance.

Critically, as shown earlier, the ESM entrusts the European Commission, in liaison with the ECB, to assess the financing needs and negotiate the Memorandum, as evidenced by the fact that for the MoU to carry legal effects, it must be approved by the BoG; a signature by the Commission will not suffice.

In Pringle, the CJEU made it clear that the duties of the Commission and the ECB, “important as they are, do not entail any power to make decisions of their own”.⁶³ This is a principal-agent relationship: as the principal, the ESM allocates tasks to the Commission in liaison with the ECB, with both acting as agents. Since the ESM is the principal in this relationship, it is legally responsible and accountable for decisions taken as part of the MoU.



'Swimming against the tide'

Table 12: Deficit accounting: from the deficit in one year to the next

	EUR million	% of GDP
2009 deficit (outcome)		
primary deficit drift in 2010	36 624	15.8
change in interest expenditure	5 681	2.5
measures in 2010 1	894	0.4
impact on ratio of nominal GDP growth	19 074	8.4
	--	0.3
2010 deficit (outcome)	24 125	10.6
primary deficit drift in 2011	10 592	4.9
change in interest expenditure	1 964	0.9
measures in 2011	16 680	--
impact on ratio of nominal GDP growth	--	0.6
2011 deficit (estimate)	20 002	9.3
primary deficit drift in 2012		
change in interest expenditure		
measures in 2012		

SOCIAL IMPACT ASSESSMENTS AND HUMAN RIGHTS OBLIGATIONS

The practice of the IMF – the ESM's closest peer institution – to carry out social impact assessments for its programmes is not shared by the ESM. Our understanding is that the first substantial social impact assessment of the memoranda was carried out by the European Commission as late as 2015.⁶⁴ This is regrettable, given extensive independent studies on how austerity has damaged Greece's social and economic infrastructure, particularly in areas such as health care.⁶⁵ As an IMF study concluded, ex ante and ex post assessments "can help design policies that are more pro-poor, better define compensatory and complementary measures where appropriate, and support country ownership of reforms by promoting a public debate on trade-offs between policy choices."⁶⁶ Senior IMF staffers have recently insisted that further austerity-focused economic policies in Greece can only be harmful.⁶⁷ A recent report by the National Bureau for Economic Research, a prestigious think tank, has established that austerity has had a much greater negative impact on output than previously believed.⁶⁸

Several empirical studies published in internationally prestigious journals have, in a dispassionate manner, documented the extent to which the effects of the

conditionality contained in the memoranda with Greece have put the socio-economic rights of Greek citizens into doubt.⁶⁹ While it is clear that part of the blame rests with the weak capacity of the Greek state to distribute the costs of adjustment, in particular via a fairer tax collection performance,⁷⁰ it is hard to demonstrate that the negative effects of the deep expenditure cuts demanded in the memoranda would have been dramatically reduced if the Greek state had boosted its administrative capacity to the levels expected by its creditors.

Although the ESM is not legally obliged to observe EU law, Art. 13(3) ESM Treaty provides that any MoU "shall be fully consistent" with those aspects of EU law that concern economic policy coordination, which notably do not include the Charter. However, the CJEU in the Ledra case (see case study 3 below) held that the Commission, although acting within the ESM framework, "should refrain from signing a memorandum of understanding whose consistency with EU law it doubts".

The key point here is that it is unrealistic to expect that the citizens of the country affected should understand these rights other than in the terms stipulated by the EU Charter of Fundamental Rights. Although the Charter is not binding on the ESM, it nevertheless constitutes the most important reference point for how European

citizens interpret these rights and should be factored into social impact assessments, and should be adhered to in preparation of the ESM's eventual entry into the EU treaty framework.

The votes of the Member State representatives sitting on the BoG and BoD also constitute state acts and fall under the general human rights obligations that their sovereign assumed. Since all ESM members ratified the International Covenant on Economic, Social and Cultural Rights, it should be of concern that the UN special rapporteur on foreign debt and human rights found that the memoranda undermine a litany of the socio-economic rights stipulated in the International Covenant, from the right to health to the right to housing. Given that human rights are a constitutive part of the values of the EU, it would be awkward to object that this International Covenant is not legally enforceable.

IMF-ESM DISCORD: EUROPEAN CONFLICTS OF INTERESTS

In October 2015, the ESM's Managing Director gave a long interview to the Financial Times⁷¹ in which he defended the case against a debt write-down (or nominal debt haircut, in technical terms) for Greece that would be on the scale that the IMF had advocated in its 2015 debt sustainability analyses, and which the Greek government preferred. Mr Regling clarified that the crucial difference between the ESM's methodology and the IMF's assessment was a different timescale for looking at Greek debt. The IMF asks to be repaid within a relatively short period of ten years, while the ESM is reducing Greece's debt burden by agreeing to much longer maturities (32 years) and lower interest rates than those charged by the IMF. The IMF's prioritisation of the overall debt burden ("stock") in their debt sustainability reports was not applicable to Greece, Mr Regling argued, because Greek's annual debt payments ("flows") were low relative to almost all other European countries. In effect, the argument goes, over the long-term horizon, the ESM Member States gave Greece an indirect debt restructuring without the need to reduce the nominal value of Greek debt. It should be noted that such an implicit debt write down has the advantage that it does not require the German parliament to vote on it, something that is widely regarded as highly unlikely to happen.⁷² In the same interview, Mr Regling reassured the public that the IMF's views were beginning to converge with the ESM's.

A year later it became clear that the IMF remained reluctant to agree with one of the less publicised aspects of the ESM's assessment: the size of the primary surplus (the budget balance before interest

payments) demanded in exchange for the long-term financial assistance. In December 2016, Maurice Obstfeld, IMF Chief Economist, and Poul Thomsen, Director of the IMF's European Department, in December 2016 took the unusual step of publicly disagreeing with the European plan for sustained and significant primary budget surplus. The two senior economists insisted that the primary fiscal surplus of 3.5 per cent of Gross Domestic Product (GDP) that Greece had to achieve by 2018 "would generate a degree of austerity that could prevent the nascent recovery from taking hold", proposing instead a lower primary surplus of 1.5 per cent in 2018. According to Obstfeld, the higher bar set by the European institutions entailed the adoption of additional austerity measures beyond those agreed initially, with the Greek government agreeing with the European institutions (and against the advice from the IMF) to cut spending further. The IMF also held that "cuts have already gone too far, but the ESM program assumes even more of them, with an increase in the primary surplus to 3.5 percent of GDP achieved through further cuts in investment and discretionary spending (...). If Greece agrees with its European partners on ambitious fiscal targets, don't criticize the IMF for being the ones insisting on austerity when we ask to see the measures required to make such targets credible."⁷³ The ESM's spokesperson officially expressed dismay at the IMF's move, and hoping for a "return to the practice of conducting program negotiations with the Greek government in private".⁷⁴

Further complicating matters, the German member on the ESM's Board of Governors has explicitly made the ESM's loans contingent on the participation of the IMF.⁷⁵ Given that Germany holds a de facto veto over ESM decisions even if the emergency procedure were applied, this is a real risk. The stand-off must be resolved by July 2017, when Greece has to make a €7 billion payment to the European Central Bank.⁷⁶ To fulfil this payment to the ECB, Greece needs fresh funds from the ESM. Both the ESM as dispenser of the funds as well as the ECB as the recipient take part in the Troika/Quadrige missions to Greece, whose positive assessment is needed to allow further ESM payments.

It is not within the scope of the expertise of Transparency International to adjudicate a debate on macro-economics between the IMF and the ESM. However, the open conflict brings to the fore the importance of having a more transparent process of loan programme design. In order for millions of citizens affected by the outcome of these negotiations to better understand why the ESM reached different conclusions than the IMF, an institution with a great deal of experience in sovereign debt restructuring, the ESM should be more specific about what reasoning, metrics and models were used to calculate debt sustainability.

A higher level of transparency will help an informed debate among macro-economists, to show how far the new ESM methodology may or may not be superior to the IMF's. We believe this is an aspect of transparency that must be improved upon.

If a real debt write-down is needed, then this should be debated and communicated in a transparent way, even and especially if this should require that creditors share the burden and forgo part of their claims. The Financial Times opines that Greece would "never" achieve a primary surplus of 3.5 per cent, and certainly not over many years, concluding that "Greek debt sustainability was thus premised on an obviously unfulfillable assumption".⁷⁷

As of February 2017, the IMF's Executive Board remained divided over whether to participate in the third Greek programme, with the ESM's Managing Director and Eurozone Member States calling on the IMF to partake in the €86 billion bail-out, while the IMF continues to report Greece's debts as following an "explosive path".⁷⁸



TRANSPARENCY IN LAW

EU transparency standards do not apply to the ESM, though specific confidentiality provisions exist. The ESM's By-Laws contain some rules on disclosure, but no access-to-document procedure is in place. As long as documents are drawn up by the European Commission on behalf of the ESM, these fall under EU transparency rules.

Specific rules for the disclosure of documents are set forth in the ESM By-Laws⁷⁹ and a host of other documents.⁸⁰ Some observers argued that “confidentiality and secrecy are the rule and transparency and disclosure the exception” in the case of the ESM.⁸¹ In its 2014 resolution on the Troika, the European Parliament too emphasised the lack of transparency of the BoG proceedings.⁸² Indeed, a forceful obligation of professional secrecy is imposed on the current and former leadership teams.⁸³

Explicit confidentiality requirements apply to the minutes and the summary records of the proceedings of the Board of Governors, the Board of Directors and of their respective committees, the Management Board and the Board of Auditors (BoA). Specific confidentiality requirements are also imposed on the members of BoA.⁸⁴

The most important challenge to the establishment of a more comprehensive transparency regime is that the ESM remains outside of the scope of the EU Treaties, so it does not need to comply with Regulation No. 1049/2001, which allows citizens to request access to documents held by EU institutions and bodies. Only the Member States can change this situation, although there are no provisions for incorporating the ESM within the Treaty framework.

The general framework of the EU transparency regime enters the ESM through a narrow but important back door: the documents held by the ESM – but drawn up by or on behalf of the European Commission, the ECB or the IMF – may be disclosed in accordance with the rules governing the disclosure of the documents of the relevant institution.⁸⁵ While this deferment contributed to an already unseemly patchwork of transparency rules applicable, this provision subjects this category of documents to the general EU transparency framework under Regulation No. 1049/2001 on public access to documents applicable to the EU institutions.⁸⁶

Within the framework of the ESM Treaty itself, no procedure for the disclosure of documents held by the ESM exists, although the Transparency Initiative (see Transparency in practice below) has greatly expanded the number of documents proactively published on the ESM's website. The requirement of disclosure is closely

related to financial audit, rather than substantive political decisions-making and the discussions surrounding the trade-offs inherent to these decisions.

The Code of Conduct for the MD and ESM staff introduces a significant nuance: “the duty of confidentiality does not prevent the Directors and the alternate Directors from providing comprehensive information to national parliaments, in case this is foreseen at national level”.⁸⁷ In practice, this means that the MD will refer requests for information or documents by national parliaments of ESM Members to the relevant government (in line with Article 17(11) of the ESM By-Laws). It would therefore be inaccurate to infer that the MD enjoys wide discretion as far as the disclosure of documents to national parliaments is concerned.

The BoG has the right to preclude disclosure of documents “when necessary or appropriate for an overriding public interest or to effect the intent and purpose of the Treaty” (Article 17, ESM By-Laws).⁸⁸ However, the key phrase “overriding public interest” is left undefined.

↓ ***The ESM should institute a procedure for requesting access to ESM documents.***

↓ ***Revisions to ESM By-Laws should define what constitutes “overriding public interest” as a basis for precluding the disclosure of ESM documents.***

However, it is important to stress that Article 17 does not apply to the flow of information between national governments and the parliaments of ESM Members (cf. Article 17(1) lit. b of the ESM By-Laws). Therefore, it is the government of the Member State concerned, not the Board of Governors, which takes the ultimate decision when it comes to the forwarding of ESM documents to a national parliament.

TRANSPARENCY IN PRACTICE

In practice, transparency has advanced beyond the legal requirements. Eurogroup President Dijsselbloem introduced the Eurogroup's "Transparency Initiative" into the ESM, leading to the central publication of a larger trove of programme documentation. While this is a positive step, only the meeting minutes of governing bodies would allow citizens to hold their governments accountable, and to know what trade-offs and arguments compelled a change in position.

TRANSPARENCY INITIATIVE

In practice the relatively restrictive transparency regime of the ESM has recently become more relaxed than its founding documents suggest. Following the Eurogroup Transparency Initiative initiated by Eurogroup President Jeroen Dijsselbloem, the ESM's BoG, which is also presided over by Mr Dijsselbloem, endorsed the "ESM Transparency Initiative" on 16 June 2016. The main additional benefit vis-à-vis the Eurogroup initiative is that programme-related documents will be proactively published on the ESM website, whereas previously, some national parliaments published the information while some did not, leading to an uneven situation. As stated in the summary of decisions of that day, the initiative is also expected to "help the general public to become better acquainted with the role of the ESM as the crisis resolution mechanism of the euro area".⁸⁹

Specifically, the ESM now discloses on its website all programme-related documents such as the pre-meeting annotated agendas of the BoG and BoD, key draft and/or final programme documents ("such as draft Memoranda of Understanding, draft financial facility agreements, the assessments by the Troika/Quadrige on risks to financial stability, debt sustainability analyses and financing needs, ahead of Board of Governors and Board of Directors meetings"),⁹⁰ summaries of BoG and BoD decisions and approved programme-related documents.

All macro-economic loans, financial assistance facility agreements, Memoranda of Understanding, supplemental memoranda, proposals for the makeup of specific tranches, complete with all terms and conditions, can be found on the website in searchable PDF formats (by country) and under the "Legal Documents" rubric.⁹¹ Following the launch of the ESM's new website in December 2016, one can easily find "explainers" on each of the ESM financial assistance programmes. Similarly, the two-page summary of the first meetings of the BoG (16 June 2016) and BoD (17 June 2016) since the introduction of the Transparency Initiative are also available on the ESM website in searchable PDF format and can be found in the respective "Meeting documents library" in the "About us" rubric. These are welcome improvements.

The Transparency Initiative, however, allows for exceptions from the disclosure rule. The first exception is concrete: sovereign bond market risk. ESM representatives make a convincing argument that a debt re-profiling with market impact cannot be revealed, as investors could take positions that may defeat the purpose of the supportive ESM intervention. Therefore, the ESM can only fulfil its mandate as lender to Member States in distress if it maintains its capacity for discretion with regard to bond market risk. The other exceptions are much broader and therefore award ESM senior management with considerable discretion, as it relates to information "where disclosure would prejudice the legitimate interests of the ESM Member requesting or in receipt of stability support; threaten the euro area stability or cause disruption in the financial markets; other information for which confidentiality would need to be ensured pursuant to the ESM By-Laws"

↓ ***The ESM By-Laws should more narrowly define the exceptions from disclosure.***

PROGRAMME REVIEW TRANSPARENCY

Negotiations ongoing as of late 2016 and early 2017, surrounding the implementation review of the third Greek financial assistance programme, are an example of the limited level of transparency surrounding the assessments made by the institutions, leading to very different interpretations between the ESM and the IMF, but also between ESM Member States.

It is worth noting the IMF was heavily criticised for making its position public in a late-2016 blog post.⁹² This is regrettable, as public debate involving think tanks, academia and civil society is the fastest and most reliable way to ascertain the evidence and reach optimal outcomes for all involved. In the uncertain social sciences, assumptions made about economic reforms and outcomes should be made transparent and reviewed by default. Disagreements between the Troika or Quadrige institutions should be addressed

and debated in an open manner, including disclosure of economic models and assumptions made, with the same level of detail as in IMF practice.⁹³

✓ ***Economic models and underlying assumptions used by the ESM, including those used to compute debt sustainability, should be made public to allow an informed debate.***

BOARD OF GOVERNORS/EUROGROUP MEETING MINUTES

The minutes of the BoG meetings are confidential as per Article 17(6) of the By-Laws. This means that, even if there were a procedure to petition for access to ESM documents, the minutes would be highly unlikely to be released. ESM staff further told us that no verbatim minutes are taken, meaning that even for internal use, operational conclusions and summaries have to suffice.

Given that the decisions are reached by mutual agreement, it is clear that every minister voted in favour (or abstained). To the extent that the minister changed their position, it is impossible for citizens to know what trade-offs or arguments prompted this change. Asked about this, ESM representatives pointed to the Eurogroup, which, as an informal consultative body, does not have the formal authority to take decisions at all.

If citizens wanted to turn to the Eurogroup to petition for the release of a document, one should turn to the General Secretariat of the Council of the EU.⁹⁴ However, the Eurogroup too takes a restrictive view on applying the access to documents regulation. According to its president, “EU Regulation 1049/2001 does not apply to the Eurogroup, it not being an institution or body within the meaning of the Treaties, as recently judged by the European Court of Justice in the Cypriot bail-in cases.” This problem is amplified by the fact that “the bulk of the Eurogroup documents is prepared by the European Commission or the ESM”,⁹⁵ limiting the scope of documents citizens may ask for.

As regards the meeting minutes, Mr Dijsselbloem notes that “the Members of the Eurogroup may meet in their capacity of Governors under the European Stability Mechanism Treaty”, which is “of an intergovernmental nature and hence, not covered by the EU Treaties’ provisions on transparency”.⁹⁶ This takes advantage of the Eurogroup’s informal nature and of the ESM intergovernmental set up in order to ensure the secrecy of the Eurozone’s economic governance

as negotiated behind the closed doors of its finance ministers’ meetings.

The Board of Governors, acting by qualified majority, may derogate from the rules of the By-Laws concerning disclosure “when necessary or appropriate for an overriding public interest or to effect the intent and purpose of the Treaty”.⁹⁷ To date, the BoG has never made use of this article to adopt such derogations.

The IMF as a peer institution publishes detailed verbatim Board minutes after a delay of five years, with ongoing internal discussions in favour of a timelier publication.⁹⁸

✓ ***Meeting minutes of the BoG and BoD should be published, within a delay if needed.***

The ESM BoA holds around 10-12 meetings per year and undertakes up to two independent performance audits of the ESM operations per year. However, the scope of BoA activities is broader. During its meetings, it monitors and reviews the work and independence of the Internal Audit Function and the external auditors. In this context, the BoA reviews the results of all audits performed by the ESM Internal Audit function (around 10 audits per year) and discusses the ongoing external audit work. Furthermore, the Board of Auditors reviews the working papers of the external auditor with regard to the statutory audit of the annual financial statements.

This practice of intense auditing is also intended as an example of transparency, as the BoA’s findings are published online in an Annual Report summarising the BoA’s meetings, audit work and its recommendations for the respective year. This report is circulated to national parliaments, the supreme audit institutions (SAIs) of the Member States and the European Parliament, along with comments from the ESM’s management. Recently, the reports appeared on the websites of several national parliaments. Specifically, the Dutch, Irish and Maltese parliaments, made the BoA Annual Reports and ESM management comments publicly available on their websites in line with their national disclosure and transparency rules, while others did not publish them. We commend the BoA and the BoG for agreeing to publish the 2015 BoA Annual Report to the Board of Governors on the ESM website.⁹⁹

ACCOUNTABILITY IN LAW

The fact that the ESM is outside the EU treaty framework presents major challenges. The ESM is not accountable to the European Parliament, Commission, Court of Auditors, Anti-Fraud Office, or Ombudsman. Judicial review is limited to Member States. Democratic accountability only happens in a de-centralised manner, though parliamentary prerogatives are uneven among Member States, and individual finance ministers cannot necessarily be held accountable over the ESM's actions.

ACCOUNTABILITY OUTSIDE THE EU TREATY FRAMEWORK

The decision of the CJEU in *Pringle* expressly stipulated that the EU Treaties do not confer any specific competence on the Union to establish a mechanism such as the ESM. The ESM can only become a full subject of EU law if EU Member States decide to make it so. That said, the ESM's activities intersect with those of EU institutions such as the ECB and the European Commission, although it is not accountable to them. It could be accountable to the Eurogroup, if this were a formal institution, and if its composition were not identical to that of the ESM's highest governing body, the BoG. Finally, the members of the BoG are accountable to the Euro Summit, the euro area composition of the European Council, and de-centrally accountable to national parliaments, much in the way classic international organisations are.

The establishment of the ESM should be seen in the broader context of the rise of intergovernmentalism as a crisis-management approach within the EU. This arose from the fact that the EU founding treaties did not foresee 'bail-outs', denying European institutions a legal basis on which to act. The intergovernmental nature of the ESM is a crucial aspect that has a whole series of knock-on effects for the work of the ESM, most of which are detrimental.

This is not limited to the hollowing out of EU law that would otherwise be applicable, such as the Access to Documents Regulation (No. 1049/2001), fundamental rights charter or integrity provisions flowing from the EU Staff Regulation. First and foremost, embedding the ESM in the EU treaty framework would enable it to take advantage of the services of and synergies with a range of EU bodies and institutions.

The ESM is not accountable to the European Court of Auditors. Only internal audits are allowed via the ESM's own Board of Auditors, where the European Court of Auditors appoints one of the five members. While there is an undoubted need for ongoing internal audits, external European auditors are better placed to perform independent audits, complementing the internal audit arrangements. The European Court of Auditors could also add an additional layer of performance audits that

goes beyond mere financial accounting, looking at the efficiency and appropriateness of procedures. Past audits have had to carefully tread around the ESM, focusing on EU institutions' implementation of the ESM's programmes.¹⁰⁰

The ESM could furthermore rely on the expertise of OLAF – the EU's Anti-Fraud Office – and outsource mediation with EU citizens to the European Ombudsman, especially given as institutions involved in financial assistance programme conditionality tend to be unpopular. The EU Staff regulation would apply, and disputes could be settled before the CJEU's General Court¹⁰¹ for the resolution of staff disputes. Instead, the ESM decided to set up an ad hoc ESM Administrative Tribunal, with its own statute and procedures – quite a disproportionate investment for an institution with fewer than 200 staff.¹⁰²

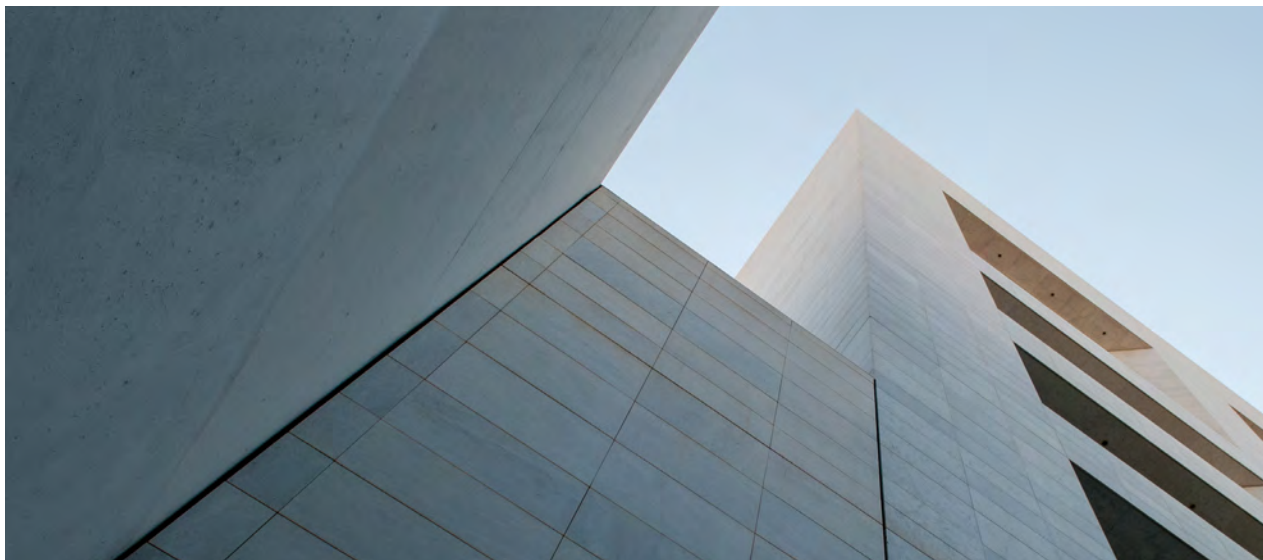
JUDICIAL REVIEW

Judicial accountability vis-à-vis the CJEU is virtually non-existent under the current framework of the ESM Treaty, excluding also the EU Charter of Fundamental Rights and its obligations, such as those pertaining to good administration.

Neither the decisions of the ESM, nor its related acts (such as Memoranda of Understanding or Eurogroup statements)¹⁰³ are subject to the judicial review of the CJEU. There is one exception to this rule: The Court is granted jurisdiction by the ESM Treaty in relation to disputes between ESM members, with regard to interpretation of provisions of the ESM Treaty.¹⁰⁴ This is based on Art. 273 TFEU, which allows EU Member States to extend the CJEU's jurisdiction "under a special agreement between the parties", to "any dispute between Member States which relates to the subject matter of the Treaties".

Individuals cannot challenge the decisions made by the ESM. Their only way of appeal is indirect and contingent on the role played by the EU institutions under the ESM Treaty. This was confirmed by the CJEU itself in its September 2016 judgment in the *Ledra Advertising* case brought by depositors from Cyprus who had lost money due to the "bail-in" of its banks (see Case study 2). While the judgment clarifies the judicial accountability mechanism for EU

CASE STUDY 2: Cypriot ‘bail-in’



Faced with debt refinancing difficulties, Cyprus requested financial assistance from the ESM between 2013 and 2016. The MoU with Cyprus requested, among other things, that bondholders and depositors should bear a part of the costs of bank recapitalisations and bankruptcies. Specifically, the MoU requested “the conversion of 37.5% of Bank of Cyprus’s uninsured deposits into shares with full voting and dividend rights, and for the temporary freezing of another part of those uninsured deposits, whilst it is stated that, should the Bank of Cyprus be found to be overcapitalised relative to the core tier one target of 9% under stress, a buy-back of shares will be undertaken to refund holders of uninsured deposits by the amount of the overcapitalisation.”¹⁰⁵ This led the complainants (Ledra et al) to challenge this MoU clause before the EU General Court and then, via the appeal procedure, at the European Court of Justice.

The General Court declared the complaints as inadmissible, stating that the MoU (and the Eurogroup statement to that end) could not make the object of an annulment procedure, by which the CJEU may revoke legal acts, given that the Eurogroup was not an EU institution and that the EU institutions signing the MoU did not have authorship over it, for judicial review purposes.

The Court of Justice agreed, but only in part, while repeating its judgment in *Pringle* that the ESM rests outside the scope of EU law. Critically, however, the Court found that even if the Commission and the ECB are not the authors of the MoU, their involvement in its adoption may be unlawful and may make the EU liable. The Court stated that the Commission continues

to function as “guardian of the Treaties” even when acting on behalf of the ESM and therefore should have enough agency as to “refrain from signing a memorandum of understanding whose consistency with EU law it doubts,” including, therefore, the EU Charter of Fundamental Rights. Any potential violations of this kind should, however, amount to “a sufficiently serious breach of a rule of law intended to confer rights on individuals” and not fall under the exemptions granted in the Charter.

However, based on the consideration that the right to property is not absolute, it held that the ‘bail-in’ measures, which were required by the MoU and challenged by the complainants, did not amount to a disproportionate and intolerable interference with the applicants’ right to property. Given in particular “the objective of ensuring the stability of the banking system in the euro area, and having regard to the imminent risk of [greater] financial losses to which depositors with the two banks concerned would have been exposed if the latter had failed”, such measures did not amount to “a disproportionate and intolerable interference impairing the very substance of the appellants’ right to property.” Consequently, the Court found that the MoU’s impact on the right to property was justified and demands for compensation should be rejected.

The main lessons of the *Ledra* case is procedural, however: individuals can challenge the MoUs via an action for damages against EU institutions, but not the ESM, for the breach of Charter provisions, through the use of national courts, but not via the annulment procedure.¹⁰⁶

institutions acting within the framework of the ESM Treaty, and as such is a step in the right direction, the threshold for citizens affected remains very high.

EUROZONE MEMBER STATES

As previewed in the section on independence, the accountability of the ESM towards the Member States far exceeds that of its peer institution, the IMF. The main reason is that the ministers of finance serving as Governors can be held to account by their national parliaments. The risks resulting from ESM activities are borne by ESM Member States through their capital contributions, which comprise (i) paid-in capital of over €80 billion and (ii) subscribed capital (also called committed callable capital) for a total of, taken together, €704.8 billion. As such, national parliaments and their budgetary privilege are involved. The degree to which the ESM is subject to parliamentary oversight at the national level is unparalleled in its peer institutions. The finance ministers appear before their respective parliaments to explain or seek a mandate for decisions related to ESM activities. The ESM's MD has made himself available to national parliaments to present ESM activities and, when necessary, provide explanations.

This high degree of de-centralised parliamentary accountability is partly rooted in the ESM Treaty's excessively restrictive transparency provisions. Indeed on 27 September 2012, the ESM Member States adopted an interpretive declaration abiding by the request of the German Constitutional court (BVerfG). The latter had held that the German ESM ratification would be in line with the German Constitution only if Articles 32(5), 34 and 35(1) ESM Treaty regarding professional secrecy and immunities did not prevent the Bundestag from being informed of all relevant measures undertaken by the ESM.¹⁰⁷

Accountability to the Member States also comes via the judicial channel. Unlike in the EU legal framework, whereby Member States and EU institutions may file a case before the CJEU for a failure to act (Article 265 TFEU), the ESM Treaty does not establish ex ante or ex post challenges to the CJEU by the European Parliament or the Commission. The competence of triggering judicial review over the decisions of the ESM lies with the Member States only. This raises the politically thorny question of whether there is a neutral control mechanism over the ESM. An expert deposition made in the UK parliament is characteristic of these concerns: "I think the alternative scenario of interstate suits without the Commission holding the gun, as it were, is almost non-existent. It is simply not going to happen. Member States are not going to sue each other for breach of their respective balanced budget rules."¹⁰⁸

However, this accountability to the Member States only concerns their individual (capital) share in the functioning of the ESM, and not accountability of the ESM as such. There are no ESM Treaty provisions on the exchange of information with national parliaments, other than the obligation of the BoD to make the annual report of the ESM Board of Auditors "accessible" to them.¹⁰⁹ Also, there are no specific provisions to inform the national parliaments on a regular basis.

As noted above, important decisions of the BoG (assistance programmes, issuing new capital, changing the permitted range of financial instruments) must be adopted by unanimity. This gives every Member State a de facto veto over key decisions. In some countries the finance minister must obtain national parliamentary support before the BoG vote if it concerns programme disbursements. For example, for the approval of a tranche in the Greek programme, the Dutch Governor had to ask for the permission of the Dutch Parliament in a special session convened during the parliamentary holiday. In other, less politically sensitive areas (changes in the ESM By-Laws, approving annual accounts, the appointment of the MD), the BoG only needs qualified majority and therefore individual Member States' leverage decreases.

This clearly shows the inherent trade-off between ESM responsiveness and the ability to act quickly in crisis situations on the one hand, and the requirements of de-centralised accountability on the other. Additionally, some parliaments have much stronger participation rights in ESM matters than others. There is some evidence indicating that a favourable macro-economic situation was decisive for the adoption of strong parliamentary participation rights. Specifically, a favourable macro-economic situation and previously strong powers in EU affairs is a good indicator for firm parliamentary ESM prerogatives.¹¹⁰ The correlation is striking and indicates that economically stable countries tend to take a view that emphasises control over ESM funds, whereas potential debtor countries may put a premium on the ESM's ability to act when and as needed.

THE EUROPEAN COMMISSION

The ESM relationship with the European Commission (alongside the ECB) is directly addressed in several parts of the ESM Treaty. First, the Member of the European Commission in charge of economic and monetary affairs may participate in the meetings of the Board of Governors as an observer. Second, the BoG can entrust the European Commission – in liaison with the ECB and, wherever possible, together with the IMF – with the task of negotiating, with the ESM Member, an MoU detailing the conditionality attached

to the financial assistance facility. Third, it is stipulated in the ESM Treaty that, where applicable, the Board of Directors shall decide by mutual agreement on a proposal from the MD and after having received a report from the European Commission, on the disbursement of further tranches of ESM financial assistance subsequent to the first tranche. Fourth, the European Commission carries out post-programme surveillance within the framework laid down in Articles 121 and 136 TFEU. Finally, the ECB and the Commission have the right to suggest edits on the Annual Report of the ESM.

Altogether, this cooperation does not amount to “accountability”, which is not possible until the inclusion of the ESM into the EU Treaty framework enables a clearer division of labour and with it more direct accountability relationships.

THE EUROPEAN PARLIAMENT

In spite of the limitations of the ESM's accountability to national parliaments, the ESM is also not formally accountable to the European Parliament. It is worth recalling that the ESM is also not accountable to national parliaments as such, but only in an indirect manner (via their finance minister).

Under Article 3(9) of Regulation No. 472/2013 (part of the so-called ‘two-pack’), during the enhanced surveillance of a Member State, the competent

committee of the European Parliament and the Parliament of the Member State concerned may invite representatives of the Commission, the ECB and the IMF, but not of the ESM, to participate in an economic dialogue.

Members of the European Parliament have access to ESM documents only when the Commission shares information with the chairs and vice-chairs of relevant EP committees regarding the macro-economic adjustment programmes the ESM is involved with.

Ralf Jansen, the ESM General Counsel, stated that “it is the national parliaments that control the ESM. The relationship with the European Parliament can only be informal”.¹¹¹

✓ ***The ESM should formalise a voluntary accountability relationship with the European Parliament, including the legal assurance of parliamentary hearings upon request, making documents available via pre-agreed channels, answering questions within set time-lines, and the commitment to address recommendations received in the form of parliamentary resolutions.***



ACCOUNTABILITY IN PRACTICE

In practice, the ESM attempts to keep the European Parliament informed, and its representatives will make themselves available for hearings whenever possible. The strong prerogatives of some national courts and national parliaments increase accountability, but also run the risk of undermining the ESM's functioning. To the extent that the ESM makes use of EU institutions for programme implementation, those institutions are accountable under EU law.

Although not legally obliged to do so, the ESM Managing Director chose to address the European Parliament's Committee on Economic and Monetary Affairs (ECON) whenever invited by its chairperson, and expressed his availability to respond to any questions. We were explicitly reassured that the MD will face the Parliament whenever he is asked to, availability permitting. This is a commendable attitude that could serve as the basis for a formal commitment. Numerous additional contacts with the European Parliament at the level of the Conference of Presidents or with individual parliamentary groups and members were also carried out. The European Parliament also receives, for information, the ESM Annual Report as well as the ESM Board of Auditors' Annual Report that is submitted to the ESM Board of Governors.

Specifically, since the establishment of the ESM, the MD has been invited to the European Parliament three times. In September 2013, he attended a hearing on the Greek programme, which was open to the press, and, in November 2015, he participated in an exchange of views on Greece, together with the President of the Eurogroup. More recently, in May 2016, the MD took part in a hearing jointly organised by the Budget and the Economic and Monetary Affairs Committees on the proposed fiscal capacity for the euro area. In February 2017, the MD attended a plenary session on the role of financial assistance programmes and the ESM in safeguarding the stability of the euro.

In the absence of an inclusion of the ESM into the EU treaty framework, it is the position of the ESM that any form of ESM cooperation with the European Parliament cannot interfere with the responsibilities of national parliaments in matters related to the ESM as enshrined in national legislation. Consequently, the establishment of a formal MoU setting out timelines and modalities for the submission of documents, answering of questions and attendance of hearings would require the agreement of ESM Member States, via its BoG.

We think that this regular interaction with the Economic and Monetary Affairs Committee of the European Parliament bears witness to the fact that the MD is ready and willing to engage with members of the

European Parliament every time that his participation is considered necessary to explain the role and activities of the ESM within the euro area.

On the other hand, the European Parliament, too, holds that greater accountability should be possible, using its own initiative prerogatives¹¹² to assess the ESM in the context of its report on the Troika in the euro area programme countries.¹¹³

↓ ***We support the call made by the European Parliament to negotiate an arrangement for an interim accountability mechanism for the ESM.***

If, in practice, a legal conflict arises between the ESM Treaty and EU law, the latter prevails. As one legal scholar noted, "Pursuant to Article 26 of the 1969 Vienna Convention on the Law of Treaties, every treaty in force is binding upon the parties to it and must be performed by them in good faith."¹¹⁴ Accordingly, if EU law could be superseded by the creation of a new legal framework by a plurality of Member States, this would violate the *pacta sunt servanda* principle – the obligation to honour agreements. If EU Member States wish to amend the founding treaties, they need to achieve unanimity.

The CJEU 2016 judgment in the Ledra Advertising case (see Case study 2) confirmed that even where the Commission acts outside of the EU legal framework, and within that of the ESM, it retains its role as 'guardian of the Treaties' stemming from Article 17(1) of the Treaty on European Union (TEU). As such, the Commission must refrain from signing any MoU that would be inconsistent with EU law. In practice, this also has an indirect effect on the ESM. The Court also confirmed that the European Commission remains liable for any unlawful conduct in this regard, including where any MoU provisions breaches the EU Charter of Fundamental Rights.

Finally, immunity of ESM staff acting on behalf of the euro area Member States does not imply that the finance ministers on the BoG cannot be held



accountable in their own countries, as emphasised in high-profile cases before national constitutional courts. This is because BoG members serve in their dual capacity as ESM governors and as representatives of their home countries. As recently commented by legal scholars:

*The German Constitutional Court presupposed a condition for German ratification a guarantee that provisions on inviolability of documents, professional secrecy and immunity do not prevent comprehensive information to the German Parliament. The Finnish Constitutional Law Committee has, in turn, emphasized that the provision on immunity does not affect the possibility of realising legal ministerial responsibility pursuant to the national constitution.*¹¹⁵

EU CHARTER OF FUNDAMENTAL RIGHTS

Future deliberations about the broader legitimacy of the ESM's decisions in particular on the Memoranda of Understanding could benefit from an active engagement with the benchmarks set in the EU's Charter of Fundamental Rights. What is of particular interest from the perspective of the accountability of the ESM to the citizens of the EU is its legal status, as an entity that emanates from the sovereign will of the Member States and delegates critical forms of intervention into the sovereign, domestic policy arena of the programme countries to the Commission, IMF and ECB as part of the so-called Troika. Article 13(3) ESM Treaty reads:

The Board of Governors shall entrust the European Commission – in liaison with the ECB and, wherever possible, together with the IMF – with the task of negotiating, with the ESM Member concerned, a memorandum of understanding (an 'MoU') detailing the conditionality attached to the financial assistance facility.

Furthermore, Article 5.6(g) of the ESM Treaty stipulates that the BoG "gives a mandate to the European Commission to negotiate, in liaison with the ECB, the economic policy conditionality attached to each financial assistance". The activities conducted by the European Commission, in liaison with the ECB, on behalf of the ESM are covered both by the ESM Treaty and the agreement among the EU Member States of 20 June 2011. As a result, the scope of the activities carried out by the European Commission and the ECB is regulated by the ESM legal framework.

The European Commission signs the MoU on behalf of the ESM following its approval by the ESM Board of Governors. In liaison with the ECB and, wherever possible, together with the IMF, the European Commission monitors compliance with the conditionality attached to the financial assistance facility.¹¹⁹ The CJEU also affirmed that the allocation of tasks to the European Commission and the ECB by the ESM Treaty is in line with EU law.¹²⁰

In effect, the Eurozone Member States created in the ESM a non-EU body that is controlled by the ministers of finance of the Eurozone, but which leaves the adjustment programme design (the Memoranda of Understanding) and their enforcement to the Commission, the ECB and the IMF (the so-called Troika/Quadrige). As an expert from the Lisbon Council put it, "the Member States 'borrowed' the EU institutions for the use by the ESM".¹²¹

In public perception and discourse, this has led to the widespread perception that the Commission or the ECB were responsible for the programme conditionality. To help locate responsibility for the reforms, as well as programme country ownership, the ESM as the delegator to the Commission and ECB, could "establish and publish clear conditionality guidelines for its support, and back them up with operational guidance to the European Commission's negotiators in the troika".¹²²

Furthermore, some aspects of the fiscal consolidation packages and structural reforms demanded by the memoranda as conditions for financial assistance violate select provisions of the EU Charter of Fundamental Rights (collective bargaining, fair and just working conditions, social security assistance, health care) as well as of international law as regards socio-economic rights such as the International Covenant for Social, Economic and Cultural Rights.¹²³ The EU Charter of Fundamental Rights is binding on EU institutions, including the Commission and ECB while excluding the ESM.

✓ **To improve accountability in the design and implementation of financial assistance programmes and associated conditionality, the ESM should task the Commission to routinely conduct Social Impact Assessments. Under EU law, this should include the benchmarks set in the EU Charter of Fundamental Rights.**

CASE STUDY 3: Judicial review and the re-assertion of parliamentary oversight

The establishment of the ESM was a highly politicised and judicialised affair in Germany, its largest shareholder. Indeed, it was not until September 2012, when the German Constitutional Court dismissed attempts to block the creation of the ESM that the saga of ESM's approval in Germany came to a close.

The case brought before the Court came after much media, political and scholarly outcries against the establishment of the ESM. The complainants stated that the overall budgetary responsibility of the Bundestag was violated by the ESM Treaty and, as a result, the German President should not sign the parliamentary acts of approval leading up to ratification.

The injunction was filed after the Court held, in its Greece and EFSF judgment of 7 September 2011 that the parliamentary budget responsibility would be relinquished if the Bundestag gave up on its right to decide on the budgetary allotments required by the EFSF. Moreover, on 19 June 2012, the Court decided in a related case (ESM and Euro Plus Pact) that the government had not fully complied with its obligation to inform the Bundestag about key documents regarding the negotiations on the ESM and the Euro Plus Pact.

Given the negative economic and political consequences of a delayed judgment, the Court used a fast-track procedure. Deliberations that would have taken a year were compressed into two months.¹¹⁶

Speaking to a packed courthouse in Karlsruhe, the Court held that the introduction of Article 136(3) TFEU, which paved the way for the establishment of the ESM, was not constitutive, that is it did not lead to a loss of national budgetary autonomy because the article in question did not establish the ESM per se, “but merely opens up to the Member States the possibility of installing such a mechanism on the basis of an international agreement”. Critically, the Court found that decisions that affect the German Bundestag's overall budgetary responsibility “cannot be taken against the votes of the German representatives in the bodies of the European Stability Mechanism, i.e. that the legitimising relationship between parliament and the European Stability Mechanism is not interrupted”. Given that every new payment or commitment to accept liability requires a positive vote in the Bundestag, the Court thus ensured that no “automatic and irreversible procedure regarding payment obligations or commitments to accept liability” would occur. The Court also found that “it is possible to extend Germany's existing payment obligations

through a capital increase; this, however, would require the assent of the legislative bodies”.

Second, the court held that ESM Treaty stipulations about the inviolability of ESM documents and the professional secrecy obligations of ESM representatives and staff should not be construed as preventing their duty to provide comprehensive information to the German parliament. This was a strong judicial assertion of the right of the German Bundestag to exercise parliamentary oversight over the ESM, adding an additional accountability layer to those existing in the ESM Treaty. Parliamentary oversight was further bolstered by the requirement that the Bundestag should decide on budgetary allotments to the ESM in a plenary session, not in a special parliamentary committee. Nevertheless, legal commentary suggests that this parliamentary right to information cannot be used by individuals.¹¹⁷

A few days later the ESM Member States expressed their commitment to this interpretation of the German constitutional court (in a rather ad litteram manner) via an interpretive declaration that paved the way for formal ratification.

This case brings to the fore three issues about key shareholders such as Germany:

- (1) the importance of the voice of constitutional courts on ESM issues that is distinctive from the voice of governments;
- (2) the re-assertion of national sovereignty in creditor states against the constitutionalisation of fiscal decisions at the supranational level that might affect their future fiscal policy autonomy;¹¹⁸
- (3) underscoring the limited space to make the ESM more independent on the one hand, and more accountable on the European level, on the other hand.

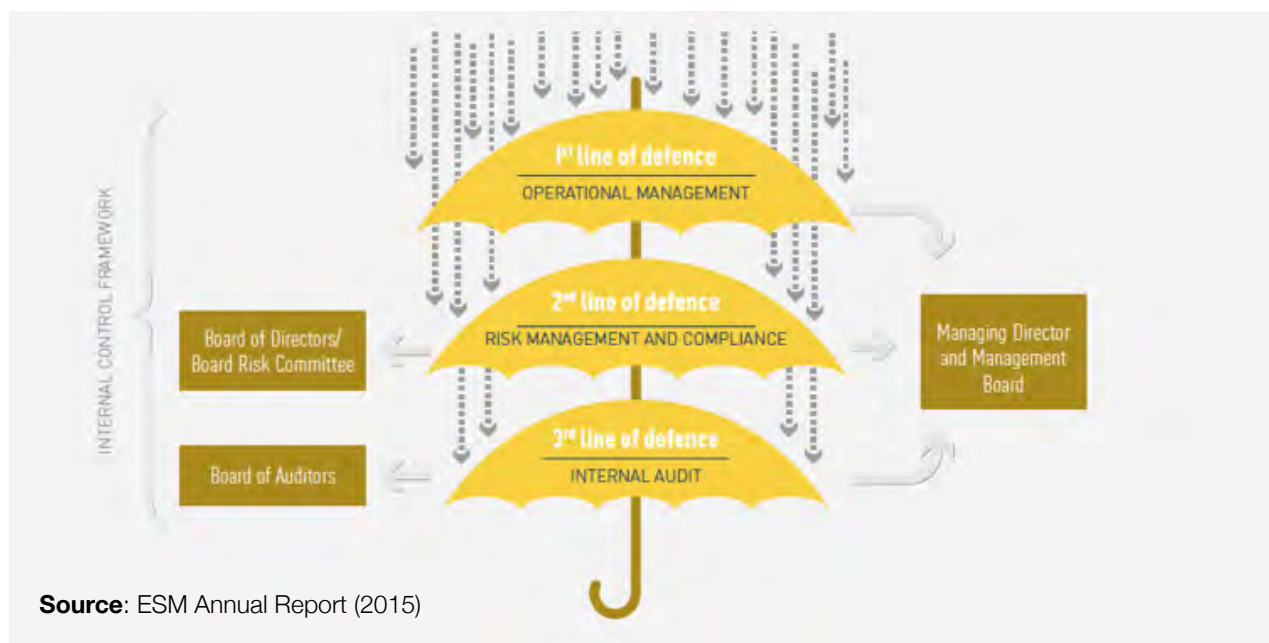
INTEGRITY IN LAW

The ESM follows international best practice for financial institutions, with ‘three lines of defence’, thorough and diligent audit arrangements. Financial safeguards are complemented by its Code of Conduct, which sets a high standard of integrity. Staff and external collaborators are required to report wrong-doing, the procedure for which is spelled out in a dedicated Whistleblowing Procedure which, while untested, meets international best practices.

THE GOVERNANCE OF INTEGRITY

Institutionally speaking, the ESM has three lines of defence in its compliance and integrity framework, as is the standard framework for financial institutions including in the private sector. Generally speaking, the ESM’s financial integrity framework follows internationally established best practices.

Figure 3: ESM internal control framework



The first line of defence is Operational Management. As its name suggests, this is a front office that manages day-to-day risks related to financing operations.

The second line of defence is Risk Management and Compliance (RaC). This body defines risk exposure, monitors and reports on the implementation of effective risk management and compliance practices by ESM Operations Management. Compliance risk at the ESM is defined as “the risk of loss and/or damage associated with the non-compliance with internal policies, procedures and guidelines as well as any external policies, regulations and directives which might govern the ESM.”¹²⁴

There is a broad spectrum of areas within the RaC competence: Code of Conduct (CoC) issues, the implementation of internal policies, conflicts of

interest, market conduct and the implementation of information barriers to regulate the flow of sensitive information; Anti-Money Laundering, financial sanctions and corruption prevention controls; personal privacy requirements.¹²⁵ The Legal Department assists the RaC by providing legal advice on the interpretation of the CoC, whether at the request of the MD or the RaC itself.

The ESM Compliance Charter ensures the independence of this compliance function from the ESM’s business operations. To avoid conflicts of interest, the Compliance Officer has only compliance-related tasks, (no employees in other divisions have compliance-specific tasks) and reports directly to the Head of Risk and Compliance, who in turn reports directly to the MD. Article 6 of the ESM Compliance Charter¹²⁶ specifically foresees that the Compliance Officer, via the Head of Risk and Compliance, has the

right to escalate issues to the Board of Directors, if necessary. Moreover, further safeguards exist in the High Level Principles for Risk Management,¹²⁷ which specify that the Chief Risk Officer, as Head of Risk and Compliance, has “direct access to the Board of Directors and its risk committee without impediment”. Lastly, the Board of Auditors periodically invites the Compliance Officer for meetings in order to discuss compliance-related matters. In principle, such meetings could also be used to escalate matters to the Board of Auditors.

Furthermore, RaC staff have unfettered and direct access to “all areas, systems and documents or records deemed necessary for the performance of these responsibilities. This shall also include the right to obtain information and/or explanations from all staff members that the function reasonably believes are necessary to perform its duties. ESM staff shall assist the function by supplying the information requested”.¹²⁸

Finally, Internal Audit (IA) represents the third line of defence on integrity. This body is tasked with providing “a systematic and disciplined approach to evaluating and improving the ESM’s risk management, internal control and governance processes”.¹²⁹ Its independence is weaker than that of the RaC and consists only of the provision that it reports directly to the MD. Internal Audit adheres to the Institute of Internal Auditors Code of Ethics and the International Standards for the Professional Practice of Internal Auditing. The specific objectives of the IA are set in the ESM Internal Audit Charter, which is available online.

All three lines of defence presented above report to the MD and his Management Board, with the Risk Management and Compliance and Internal Audit also reporting to the BoD’s Board Risk Committee and Board of Auditors respectively. In our view this is an adequate institutional structure for the task at hand.

THE CODE OF CONDUCT

The ESM Treaty has no provisions related to possible conflicts of interest and it falls on the BoG to lay down what activities are incompatible with the duties of the Directors.¹³⁰ Awarding such discretion to the BoG is the norm for the Code of Conduct: “The Director or the Alternate Director may not engage in such activities as may be determined from time to time by the Board of Governors”.¹³¹

Nonetheless, the members of ESM staff “must avoid” situations of conflict of interest understood as “a situation or circumstances in which private interests of members of staff influence or may influence the objective and impartial performance of their duties. Private interests include any advantages for members

of staff, their families or personal acquaintances”.¹³² Private dealings with ESM counterparties regarding any borrowing, investment, stability support operation or other activity shall be reported to the Compliance Officer, as shall private relationships among staff.¹³³

We are concerned that there are no checks on conflicts of interest at the meetings of the BoG and BoD. In the view of ESM representatives, the complex assessments of market counterparties, as well as the enforcement of the CoC and the Procurement Policy, should suffice to avoid conflicts of interest. We believe this argument is not strong enough to reassure European citizens at a time when distrust in European financial organisations has reached an apex.

↓ **Declarations of interests of BoD and BoG members should be kept continually updated on the ESM website.**

Despite being exempted from the EU regulatory framework for credit institutions, the Code of Conduct (CoC) specifically covers and incorporates provisions regarding insider trading. In particular, “the ESM will put in place appropriate measures designed to limit the flow of Inside Information from areas that own such information (such as, Funding, Lending, Economics & Policy Strategy, Banking, Middle Office, Risk Management) and those areas that trade in securities (Investment and Treasury)”.¹³⁴ The ESM operationalised this commitment via an Information Barriers Policy (IBP), which was designed to ensure compliance with Article 13(4) of the Code of Conduct. The IBP foresees procedures intended to limit the flow of inside information to Investment and Treasury from other divisions within the ESM. The IBP also sets forth specific rules to be upheld by departments and divisions with access to inside information.

The ESM Code of Conduct (CoC) was adopted by the Board of Directors by qualified majority and constitutes the core of the ESM integrity regime. It requires that, “Members of staff shall perform their duties in a manner that safeguards and enhances public confidence in their integrity and in the integrity of the ESM”.¹³⁵ The CoC is binding on the MD and all Directors, alternate Directors and all members of staff of the ESM. It sets forth their obligations on such matters as confidentiality, public statements and contacts with the media, personal investments and disclosure of financial and business interests.¹³⁶ The CoC also proclaims particular organisational principles, such as equality and non-discrimination that are inspired by the EU legislation on integrity.¹³⁷

In terms of its scope, the CoC applies only to staff and a narrowly defined group of externals active at

the level of ESM management (directors, observers, aides, experts).¹³⁸ It should be noted that, as a small institution, the ESM makes use of the services of external consultants at all levels in areas as diverse as research and audit, including in the early days of the institution when procedures and guidelines were likely to be less well established. This poses integrity risks for the ESM, especially given that private sector consultants are highly likely to have colleagues working for other financial market participants and other holders of Eurozone sovereign debt.

✓ ***The CoC should be amended to apply to all external collaborators and in particular consultants.***

EXTERNAL ACTIVITIES

Unless the MD gives his permission, ESM staff are not allowed to undertake professional activity, hold any political post or appointment, or act in any advisory capacity, outside the ESM. They are also not allowed to serve on the governing or management body of public or private companies, regardless of whether such activity is remunerated or not. To the extent that they are reported to the Compliance Officer, some external activities are allowed, however. These include unremunerated positions of responsibility in up to two charities or other not-for-profits “with laudable cause”, professional associations or educational institutions.

The ESM made it clear that they use the general definition of “laudable cause”, i.e. “deserving of praise”. Any external activities pursuant to Article 8(3a) of the Code of Conduct are subject to reporting to the ESM Compliance Officer, who assesses whether all conditions required under the CoC are met, including a review of the nature of activities of the charity or not-for-profit organisation. Examples of such organisations where ESM members of staff serve include:

- Foundations, charities to support hospitals or other institutions providing care to people with special needs (e.g. elderly people);
- Foundations of universities (staff would typically be involved with foundations of their alma mater);
- Foundations in the local community to support sporting and cultural activities of young people.

In case of concern, the ESM Compliance Officer refers the issue to the ESM MD, who may instruct members of staff to refrain from activities that do not benefit the purpose, role and values of the ESM or their professional duties.

The CoC applies the same exception to teaching, research and the external activity performed during leisure time for non-profits, such as volunteering. The MD has discretion to prohibit these activities on a case-by-case basis if they do not “benefit the purpose, role and values of the ESM or the professional duties of the member of staff”.¹³⁹

RUNNING FOR PUBLIC OFFICE

ESM staff can stand for public office. In this case, the MD can decide that the staff in question shall take a period of leave on personal grounds, continue to discharge their duties at the ESM, be authorised to discharge their duties at the ESM on a part-time basis, if the nature of their post within the ESM so permits, or leave the ESM in order to accept the public office.

We are concerned that the ESM can allow senior staff to continue to work for the ESM, even as they stand for public office. The main reason is that, by their very nature, ESM decisions are steeped into the domestic politics of the Member States and particularly of those Member States that see themselves as creditors. This situation poses a reputational and political risk for ESM staff involved in domestic politics while still on the job at the ESM.

GIFTS AND INVESTMENTS

Staff are prohibited from receiving gifts in the exercise of their duties unless they are “reasonable and customary”. Gifts above a token value must be declared to the Compliance Officer. Staff may not accept any gifts from third parties with which the ESM does or seeks to do business exceeding €100 (as determined by the MD). When, for cultural reasons, refusing to accept a gift may cause offence or embarrassment to the gift-giver or to the ESM, members of staff may accept gifts with a value in excess of the value set by the MD if immediately declared to the Compliance Officer, following agreed procedures (e.g. display in ESM offices or making a donation in a corresponding amount). To bolster this system situated at the intersection of basic transparency and integrity measures, it should be made public. Moreover, given that the ESM only operates within the Eurozone, in our view the acceptance of gifts in excess of a token value for whatever reason (cultural or otherwise) should not be acceptable.

✓ ***The Code of Conduct should institute the obligation for the staff to refuse all gifts with a value exceeding a token value and for***

compliance function to have a public register for gifts.

The CoC institutes prohibitions that apply to honours, distinctions, decorations or awards from any government or other public authority.¹⁴⁰ We think that this is adequate and should be extended to honours awarded by private entities.

- ✓ ***Article 10.7 of the Code of Conduct should also prevent staff from applying for, soliciting, receiving, or accepting any honour, distinction, decoration or award from any private authority without the prior written consent of the MD.***

The CoC discourages staff members from making private investments that can raise doubt about their duties towards the ESM, for their own account or on the account of others, for a total amount that exceeds €10,000 per year. The objects of these investments are tightly defined: Euro area government and supranational debt securities; euro-related foreign exchange instruments, shares in Euro area banks, and any derivatives or structured products related to the above. All staff members are compelled to file compliance declarations with the Compliance Officer in this regard. The MD, the members of the Management Board and other senior members of staff, as designated by the MD, file confidential disclosures of financial interests, but these declarations are confidential.

At the same time, the CoC leaves open a broad window to make such investments with the permission of the Compliance Officer, as long as the officer is “satisfied about the non-speculative nature of the transactions and the lack of circumstances contraindicating such transactions”.¹⁴¹ We do not doubt the capacity of the Compliance Officer to conduct thorough inquiries in this regard, but given the complexity of contemporary financial transactions and the porousness of the term ‘non-speculative’, we hold that, should staff make speculative investments and trades, the reputational fallout for the institution as a whole would be significant.

This risk is even greater in the case of the MD and senior staff. The ESM assured us that, going forward, the MD would publish a voluntary declaration of interests on the ESM website. However, for this declaration to be meaningful beyond a short-term horizon, this should be an institutionalised requirement, including for ESM management positions that are not

appointed for a term of office. This can be justified in view of the ESM’s operations that take place directly in the financial marketplace.

- ✓ ***There should be no exceptions from the prohibition imposed on the ESM staff regarding direct investments in, trades or sales of the financial instruments defined under Article 14.2 of the Code of Conduct.***
- ✓ ***Declarations of interests and financial declarations by ESM management and the Managing Director in particular should be made public.***

PROCUREMENT

As of May 2016, the ESM has a detailed and public procurement policy that meets best practices. The policy covers the procedure for calls, market research, time limits, technical specification and communication with candidates. It specifies eligibility criteria, award criteria and notification decisions.

WHISTLEBLOWING

Without an effective and well-implemented whistleblowing policy, corruption and other forms of misconduct and maladministration go understudied and under-prosecuted. Therefore, robust and clear internal reporting channels are crucial, including the formalised possibility to report anonymously and to various levels of the hierarchy (e.g. bypassing the Compliance Office or even the MD), in addition to protections against dismissal, harassment such as delayed promotions, and humiliation. These reporting channels and protections must have a strong track record in protecting previous whistleblowers from adverse consequences, to encourage prospective whistleblowers to come forward, as well as to facilitate a healthy feedback culture.¹⁴²

Article 17 institutes the obligation for all members of staff to report irregularities (defined as fraud, illegal behaviour, serious misconduct or serious infringement) and provides for confidentiality and the protection of the report. It also demands that the ESM “refrains from any retaliation or reprisal against any member of staff who makes in good faith a report of any Irregularities” and stipulates that the good faith whistleblower enjoys “assistance and protection in accordance with the ESM duty of care”.



This obligation is substantiated in a separate whistleblowing policy document entitled “Process for Handling Reports of Irregularities”,¹⁴³ and adopted by the ESM in 2014. In spite of the by-line “Whistleblowing Procedure”, the document is very hard to find on the ESM’s website – we recommend making it more directly visible, e.g. via a reporting form under the contact pages of the website.

The policy applies to all members of staff and persons not employed by ESM but making up part of ESM’s workforce temporarily on a contractual basis with their employer and having a reporting line to a member of ESM staff. Additionally, the procedure states that any reports on irregularities made by service providers or their staff will be accepted and handled in a similar way.

These are sound principles but the challenge with an effective whistleblowing procedure routinely lies in the implementation of good policies. The best way the ESM can encourage staff to report wrongdoing is by setting a positive example that allows (prospective) whistleblowers to gain confidence in what awaits them in the process.

The Whistleblowing Procedure contains specific safeguards and measures to protect reporters, and specifically commits the ESM to ensuring that no retaliation will take place against any individual who files a report in good faith. The ESM undertakes to not discharge, demote, suspend, threaten, harass or in any other way discriminate against any reporter as a result

of their report. Any form of threat, retaliation or other action against anyone who prepared or assisted in the preparation of a whistleblowing report will be pursued. Any breach of these safeguards is to be reported to the Compliance Officer.

The procedure allows for anonymous reporting and provides a template, it describes how the investigations are handled and by whom, and includes the requirement to provide feedback to the whistleblower, which reflects best practice and allows staff members who made a report to recognise whether their report is seriously considered. According to the ESM, the procedure was inspired by the principles contained in the “International Financial Institutions Principles and Guidelines for Investigations”. The IMF, as a far larger institution, went further and even instituted a so-called ‘Integrity Hotline’, whose use is actively encouraged by the Fund.

For more information on effective whistleblowing policies, see the best practices compiled in Transparency International’s Principles for Whistleblower Legislation,¹⁴⁴ as well as the Council of Europe’s recommendations on the protection of whistleblowers.¹⁴⁵

↓ ***The ESM should ensure that its Whistleblowing Policy is visible and accessible, including for external consultants and citizens.***

INTEGRITY IN PRACTICE

The ESM being a young institution, we have no indication of a divergence from the ESM's formal integrity requirements. However, the ESM does not report regularly on the implementation of its Code of Conduct, integrity breaches and whistleblowing reports.

As a young institution, the ESM does not offer many opportunities for tracing gaps between statutory requirements and their practical application. However, several issues stand out.

All staff receive training on ESM policies on integrity, and the compliance function is tasked to develop compliance-related training materials and deliver trainings.¹⁴⁶ There is also a mandatory face-to-face training session regarding the CoC for all new staff. Although there is no penalty for missing the training session, anyone not participating is individually followed-up on. Consequently, the attendance rate stands at 100 per cent.

Non-mandatory training sessions are organised to disseminate ESM policy on fraud and there is a mandatory requirement to complete a Compliance Declaration regarding the provisions of the CoC. The administration of the code falls to the compliance function and is internally audited. To promote awareness and observation of CoC's ethical norms, the ESM organises an annual "Values Day", which includes investment of time and effort on the part of ESM management.

To date, there has been no public reporting on the implementation of the Code of Conduct. The 2015 Annual Report, for instance, states that no instances of fraud were identified in that year but does not provide any information about the number of cases processed or their nature. We think that in this regard the Compliance Function could emulate the practice of its peer at the IMF, where the observance of integrity norms is detailed in 20-page reports.¹⁴⁷

✓ ***The Compliance function should report on a regular basis regarding the implementation of the CoC.***

Starting in May 2016, all staff are requested to report to Compliance all gifts above a token value (€100). Compliance keeps a list of gifts, but that is not available to third parties.

✓ ***The list of gifts should be made available in a public register.***

There is insufficient evidence that Compliance and/or Legal departments engage in adequate awareness-raising activities for all staff and service providers regarding gifts.

✓ ***There should be an ESM webpage for externals and citizens to anonymously report cases in a dedicated and accessible form.***

METHODOLOGY

Our methodology is based on the adaptation of Transparency International's National Integrity System (NIS) assessments, taking into account the characteristics of an international financial institution such as the ESM. The NIS is the methodological hallmark of TI and is based on a holistic approach to integrity. Its original main aim was to evaluate the strengths and weaknesses of the formal integrity framework of different institutions and then assess its use in practice with a view to making recommendations for improvement. Used in over 70 countries since 2001, the NIS framework looks at 13 key functions in a state's governance structure: the legislative; executive; judiciary; public sector; electoral management body; ombudsman; law enforcement agencies; supreme audit institution; anti-corruption agencies; political parties; media; civil society; and business.

In 2015, TI-EU published the first such study applying the NIS approach to the supranational level by looking at the structure of the EU's governance. In practice this meant an assessment of individual EU institutions and actors rather than evaluating specific governance functions. This TI report on the EU integrity system provided us with a useful template to create a bespoke analytical framework to examine the ESM.¹⁴⁸

Regarding independence, we examined the extent to which the ESM can act without interference from other actors and determine its own leadership and actions. Regarding transparency, our analysis dwelt on the ability of the general public to scrutinise the decision-making and actions of the ESM, in particular those aspects where there are potential corruption risks. Our work on transparency enabled us to check how well the public can examine the integrity and accountability of the ESM itself as well as of the functioning of inter-institutional oversight relations. Concerning the assessment of the ESM's integrity safeguards in law and in practice, we looked at the

level to which the behaviours and actions of the ESM staff are consistent with the ESM's own external and internal legal frameworks meant to serve as barriers to corruption.

Finally, we looked at accountability, or the extent to which the ESM can be held responsible by other democratic institutions and the broader public for executing its mandate adequately. We attempted to reveal the nature of the relationships between the ESM and EU institutions with regard to safeguarding integrity via the assessment of independence and accountability indicators. Throughout each of these sections, we took a close look at the scope of the involvement of the ESM in supporting the overall integrity of the EU governance via cooperation with other institutions such as the OLAF, the Ombudsman or the European Court of Auditors.

To date, our research took place from August 2016 until October 2016 and was carried out in two phases: 1) Desk research consisted of gathering relevant legal and policy texts, institutional reports, and secondary sources; 2) Structured interviews with members and officials of the ESM took place.

The interviews used a bespoke questionnaire based on the preliminary findings of our desk research. Their main function was to validate the findings from the desk research phase and to gather knowledge on actual institutional practices. The cooperation with the ESM was excellent and we were able to organise interviews with high- and mid-level staff without difficulty, including with the Managing Director Mr Regling.

ENDNOTES

- 1** For a comprehensive overview of its functions see Stefano Micossi, Jacopo Carmossi and Fabrizia Peirce, *On the tasks of the European Stability Mechanism* (Centre for European Policy Studies, 2011).
- 2** Article 3, ESM Treaty.
- 3** The ESM's predecessor was the European Financial Stability Facility (EFSF).
- 4** Carlos Closa and Aleksandra Maatsch, 'In a spirit of solidarity? Justifying the European financial stability facility (EFSF) in national parliamentary debates,' *JCMS: Journal of Common Market Studies* 52.4 (2014), p.826.
- 5** The EFSM is the European Commission's funding scheme that was used between 2011 and 2015, and still exists. For more see here https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-financial-assistance/loan-programmes/european-financial-stabilisation-mechanism-efsm_en
- 6** EFSF Press release of 6 February 2017, <https://www.esm.europa.eu/press-releases/efsf-raises-%E2%82%AC15-billion-new-26-year-bond>
- 7** L. Gocaj and S. Meunier, 'Time will tell: The EFSF, the ESM, and the euro crisis', *Journal of European Integration*, 35, 2013, p.239-253.
- 8** Not to be confused with the HFSF, the Hellenic Financial Stability Facility, a special purpose vehicle created under Greek law to help stabilise the Greek banking sector.
- 9** <http://www.etat.lu/memorial/2010/C/Pdf/c1189086.pdf#Page=2>
- 10** ESM, Annual Report, 2013.
- 11** Carri Ginter and Raul Narits, 'The Perspective of a Small Member State to the Democratic Deficiency of the ESM,' *Review of Central and East European Law*, 38.1, 2013, p.58.
- 12** [http://www.europarl.europa.eu/RegData/bibliotheque/briefing/2014/140568/LDMBRI\(2014\)140568_REV1_EN.pdf](http://www.europarl.europa.eu/RegData/bibliotheque/briefing/2014/140568/LDMBRI(2014)140568_REV1_EN.pdf)
- 13** Martin Hillebrand et al, *European Government Bond Dynamics and Stability Policies: Taming Contagion Risks*. No. 8. 2015.
- 14** <https://ftalphaville.ft.com/2011/01/26/469966/klaus-regling-the-record-breaker/>
- 15** The one exception is the ESM recapitalisation of Spanish banks, for which the ESM could only claim *pari passu* status.
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- 30** Article 35, ESM Treaty.
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- 56** Carlos Closa and Aleksandra Maatsch, 'In a spirit of solidarity? Justifying the European financial stability facility (EFSF) in national parliamentary debates,' *JCMS: Journal of Common Market Studies*, 52.4, 2014, p.840.
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