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EUROPEAN COURT OF AUDITORS

Summary of Special Report 18/2015 Financial assistance provided to countries in difficulties

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Summary of
Special Report 18/2015

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01

Financial assistance provided to countries in difficulties

Seven years ago, Europe faced a financial crisis which turned into a sovereign debt crisis. The sovereign debt crisis was a consequence of various factors, including weak banking supervision, poor fiscal policies and the difficulties experienced by large financial institutions (and the consequent bailout costs borne by the general public). The crisis swept across EU Member States in two waves, first affecting the non-euro area countries in 2008-2009 and later spreading to the euro area itself.

But was this turmoil well resolved? A number of legal instruments were devised to provide financial assistance. Non-euro area Member States could take advantage of the existing **balance-of-payments (BoP) mechanism**. Ireland and Portugal were helped by the newly created **European Financial Stabilisation Mechanism** (EFSM) and the European Financial Stability Facility (EFSF). Only the BoP and the EFSM were established as EU instruments on the basis of the Treaty on the Functioning of the European Union, as the EFSF is an intergovernmental vehicle outside the EU framework.

We analysed the Commission's management of the financial assistance provided to five Member States (**Hungary, Latvia, Romania, Ireland and Portuga**l) and issued process-related recommendations to the Commission.

02

What we audited

Audit scope

The audit covered the Commission's management of financial assistance provided under the BoP facility and the EFSM, for which the Commission borrowed on the capital markets using the EU budget as guarantee. The audit encompassed the financial assistance paid to Hungary, Latvia, Romania (the first two programmes), Ireland and Portugal, with an emphasis on the Commission's role in these programmes. We also examined the Commission's cooperation with its partners (the ECB and the IMF), but did not audit the partners.

We did not audit the decisions taken at the EU's political level and we limited the scope of the audit in several aspects. We did not consider the counterfactual scenario of no financial assistance or the feasibility of resolving the crises by other means (e.g. the mutualisation of sovereign debt). Nor did we assess debt sustainability or the likelihood that the loans will be repaid. We also did not evaluate if the Council had chosen the most appropriate deficit targets or structural conditions to resolve the crisis. When auditing the Commission's cooperation with other partners, we did not assess whether their involvement was justified.

03

Audit questions

We examined whether the Commission's management of financial assistance programmes was appropriate. This was addressed by the following sub-questions.

1. Were the growing fiscal risks detected on time?
2. Were processes sufficiently well designed to make a comprehensive input into programme decisions?
3. Did the Commission borrow at the best possible rates and in accordance with best debt issuance practices?
4. Did the financial assistance programmes meet their main objectives?

04

What we found?

Some warning signs went unnoticed

It is important to remember that before the crisis there was already a framework geared towards monitoring the Member States' budgets. Warning the Council about the mounting fiscal imbalances was the Commission's responsibility. The Commission was not prepared for the first requests for financial assistance.

We found that the Commission estimated the countries' public budgets to be stronger than they actually turned out to be. An important weakness of the Commission's assessments prior to 2009 was the lack of reporting on the build-up of contingent public-sector liabilities, which often became real liabilities during the crisis. Nor did the Commission pay sufficient attention to the link between large foreign financial flows, the health status of the banks and, ultimately, government finances.

Reforms to the Stability and Growth Pact in 2011, 2013 and 2014 sought to address the weaknesses of the pre-crisis period by introducing greater macro-economic surveillance. However, back in 2008 the Commission found itself unprepared to manage the financial assistance when countries started presenting their requests.

05

Standing up to the challenge

Playing catch-up

The Commission managed to take on its new programme management duties, which included holding talks with the national authorities, preparing programme forecasts and financing-gap estimates and identifying the necessary reforms. Given the initial time constraints and limited relevant experience, this was an achievement.

The Commission was mostly thorough in obtaining the information it needed. It has increasingly marshalled internal expertise and engaged with a wide range of stakeholders in the countries which appealed for help.

Complex tools

The production of macroeconomic and deficit forecasts was not a new activity. The Commission used an existing and rather cumbersome spreadsheet-based forecasting tool. Quality control was limited mainly to reconciling the various parts of the forecasts, with no inquiry by management into the reasoning behind the forecasting assumptions. It was very difficult to assess the plausibility of key assumptions such as fiscal multipliers, not only in any subsequent review but also, by management, during the actual production of forecasts.

06

Teething problems

The assistance programmes were mostly soundly based, given the prevailing EU-level policies and the economic knowledge at that time. But a common weakness of the Commission process was the lack of documentation. It was not geared towards going back in time to evaluate the decisions taken. We could not validate some of the essential information that was forwarded to the Council, such as the initial estimates of the financing gap for some programmes.

This can be partly explained by the crisis context, the initial time pressure and the novelty of programme management to the Commission. The availability of records improved with time, but even for the most recent programmes some key documents were missing.

The conditions in the memoranda of understanding were mostly justified by specific reference to the Council decision. However, conditions were not always sufficiently focused on the general economic policy conditions set by the Council.

Different approaches

We found several examples of countries not being treated in the same way in a comparable situation. The conditions for assistance were managed differently in each programme. In some programmes they were less stringent overall, which made compliance easier. When comparing countries with similar structural weaknesses, it was found that the required reforms were not always in proportion to the problems faced or that they pursued widely different paths. Some, but not all, countries' deficit targets were relaxed more than the economic situation would appear to justify.

Limited quality control

One of the reasons for these weaknesses was that the programme design and monitoring were largely in the hands of the Commission's programme teams. Before reaching the Council or the Commission, the key documents resulting from a team's work were subject to review, but this was insufficient in several respects. The underlying calculations were not reviewed by anyone outside the team, the work of the experts was not thoroughly scrutinised and the review process was not well documented.

08

Room for improvement

On the positive side, the programme documents, which provide the basis for the decisions that the Council or the Commission take, have improved significantly since the first request for financial assistance. This was due to the allocation of additional staff to programme management, more experience gained and better preparation. However, even the more recent programme documents lacked some essential information.

For monitoring, the Commission used accrual-based deficit targets. This ensures consistency with the excessive deficit procedure, but it also means that, when a decision on programme continuation is to be taken, the Commission cannot report with certainty whether the beneficiary Member State has complied with the deficit target, as accrual-based deficits can only be observed after a certain time has elapsed. The manner of reporting on compliance with conditions was not systematic.

Many different terms were used to convey non-compliance, leading to confusion. Some conditions were not reported on. A few conditions were reported to have been met when this was not in fact the case.

09

Borrowing met financing needs even though circumstances initially made it difficult to always abide by best practice

The Commission's issuance of debt was an accomplishment, as all bond issues attracted sufficient demand from the capital markets to be sold out. The Commission made the bond issues on time. The final cost of debt was in line with the market and peer levels. In terms of actual procedure, pricing levels were sometimes higher than the pricing level initially indicated by the lead banks.

There were a number of gaps in the debt management process in the initial years. These omissions can be partly explained by the limited number of Commission staff assigned to this activity. The gaps did not have a demonstrable impact on the outcome of borrowing. The gaps were largely addressed in the later bond issues, so the recommendation concerns weaknesses identified as outstanding during the audit.

10

Programmes met their objectives

The revised deficit targets were mostly met, with some exceptions. As economic activity declined in 2009, countries suffered losses in revenue which wiped out any gains from revenue measures. Tax-neutral or tax-offsetting reforms caused additional short-term fiscal costs and some countries took additional tax measures to offset the declining tax-to-GDP ratios. Structural deficits improved but at a varying pace. Part of the fiscal adjustment took place in a non-lasting way. Countries used one-off measures to meet the targets.

Member States complied with most conditions set in their programmes, albeit with some delays. These were mostly incurred for reasons beyond the control of the Commission. Occasionally, however, the Commission set unrealistically tight deadlines for wide-ranging reforms. High compliance does not mean that all important conditions were complied with. In addition, we observed that Member States tended to leave compliance with the more important conditions until towards the end of the programme period.

The programmes were successful in prompting reforms. Countries mostly continued with the reforms that were sparked by the programme conditions. Reversals of the reforms were rare at the time of our audit. They were off-set by alternative reforms, which were often not equivalent in terms of potential impact.

In four of the five countries, the current account adjusted faster than expected. This is largely explained by the unexpected improvement in income balance and to a lesser extent by the unexpected improvement in trade balance.

What we recommended?

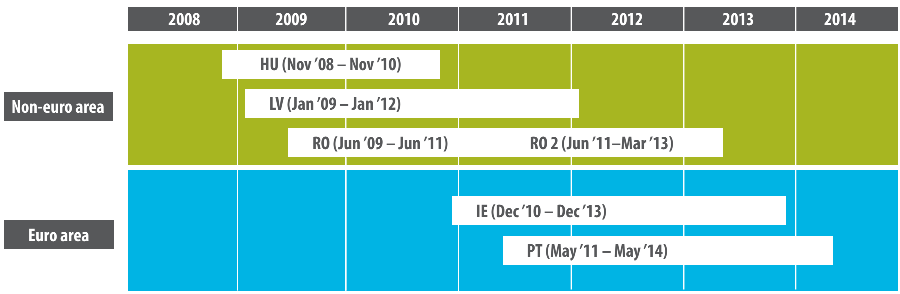
a.	The Commission should establish an institution-wide framework allowing rapid mobilisation of the Commission's staff and expertise if a financial assistance programme emerges. The Commission should also develop procedures in the context of the 'two-pack' regulations.
b.	The forecasting process should be subject to more systematic quality control.
c.	To ensure the factors underlying programme decisions are internally transparent, the Commission should enhance record-keeping and pay attention to it in quality reviews.
d.	The Commission should ensure proper procedures for the quality review of programme management and of the content of the programme documents.
e.	For budget-monitoring purposes, the Commission should include, in the memoranda of understanding, variables that it can collect with short time lags.
f.	The Commission should distinguish conditions by importance and target the truly important reforms.
g.	For any future programmes, the Commission should attempt to formalise interinstitutional cooperation with other programme partners.
h.	The debt management process should be more transparent.
i.	The Commission should further analyse the key aspects of the Member States' adjustment.

About BoP/EFSM

The purpose of these financial assistance programmes was to help countries repay or finance their maturing debt and deficits. It provided a cushion to ease the implementation of the adjustment programmes that were necessary in each country to correct underlying problems. In broad terms, the mechanisms addressed the need to safeguard the stability of the euro area or the EU as a whole, to limit the risk of contagion and to prevent a sudden shock to the economies of beneficiary Member States.

The objectives of each programme differed in detail, but the overall aims of financial assistance were to return Member States to sound macroeconomic or financial health and restore their capacity to meet their public-sector (euro area) or BoP (non-euro area) obligations.

The timeline of the financial assistance provided to the five Member States covered in our audit was as follows.



Main features of the lending facilities to the five countries

	BoP	EFSM	EFSF
Institutional form	EU mechanism	EU mechanism	Private company owned by euro area countries
Capital structure	Guaranteed by the EU budget	Guaranteed by the EU budget	Guarantees from euro area countries
Lending capacity in euro	50 billion euro	60 billion euro	440 billion euro
Instruments	Loans, credit lines	Loans, credit lines	Loans, bond purchases on the primary and secondary markets
Duration	Permanent mechanism	Temporary mechanism	Temporary mechanism
Main decision-making bodies	Council, acting by qualified majority voting on proposal from European Commission		EFSF Board of Directors (i.e. members of the Eurogroup)
Legal basis Financing	Article 143 TFEU	Article 122 TFEU	Intergovernmental decision

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